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ECONOMIC REFORM IN MEXICO: IMPLICATIONS FOR THE UNITED STATES

A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

OCTOBER 1988

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LETTER OF TRANSMITTAL

OCTOBER 5, 1988.

To the Members of the Joint Economic Committee:

I am pleased to transmit to you a study recently completed by the staff of the Joint Economic Committee on the current economic situation in Mexico and its implications for the United States.

Mexico is currently in the middle of a major re-orientation of its economy and economic policy. The country's leadership has made a major commitment to move in the direction of greater liberalization, more reliance on market forces, and substantial improvement in the government's fiscal balance. These reforms are in line with longstanding recommendations by the major multilateral financial institutions, and represent a significant change of direction for Mexican economic policy.

The United States will be profoundly affected by the way in which these policy changes shape the Mexican economy. As the study notes, the United States stands to benefit significantly from a Mexican economy which finds its way back onto a path of sustained, noninflationary growth, while a Mexico rent by economic distress can only create significant problems for this country. For these reasons, the United States needs to develop an effective set of policies to both sustain the momentum of economic reform in Mexico and ensure that the Mexican economy quickly returns to health.

The study was written by Dr. Stephen A. Quick, Chief Economist for the Joint Economic Committee, following a recent research visit to Mexico.

I hope this study will prove useful to you in understanding the changes presently taking place in Mexico.

With best regards,

Sincerely,

PAUL S. SARBANES, *Chairman.*

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ECONOMIC REFORM IN MEXICO:

IMPLICATIONS FOR THE UNITED STATES

A STAFF STUDY
PREPARED FOR THE
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I. INTRODUCTION AND SUMMARY

In both economic and geopolitical terms, few countries are as important to the United States as is Mexico. Even if the United States and Mexico did not share a common border, Mexico's economic weight would be sufficient in its own right to command priority attention from Washington. Mexico is moving into the front ranks of the critical group of "middle income" developing countries. It is the 13th largest country in the world in terms of land area, 11th largest in terms of population. It has the world's fourth largest proven oil reserves, a diversified agricultural sector, and an industrial sector larger than such industrialized countries as Sweden, Belgium and Spain and a total output of manufactured goods which exceeds that of any of the "newly industrializing countries" such as Taiwan and South Korea.

Proximity adds to the importance of Mexico for the United States. The nearly 2,000-mile border between the two countries has promoted a complex set of cultural and economic interconnections. In economic terms, Mexico ranks 5th as a source of imports into the United States, supplying some 11 percent of our oil imports and playing an increasingly significant role as supplier of automobiles and other manufactured products. More importantly, Mexico ranks third, behind only Japan and Canada, as a destination for American exports, ahead of such countries as Germany, Britain and France. Mexico is also an important location for United States overseas investment. The United States Chamber of Commerce in Mexico is the largest outside the United States, and American investment accounts for some 80 percent of total foreign investment in Mexico.

More informal, cultural ties also bind the two countries together. Hispanics are the fastest-growing ethnic group in the United States, and by the end of the century it is estimated that the Spanish-speaking population in the United States will be the world's second-largest, exceeded only by Mexico.[1] More American citizens reside in Mexico than in any other foreign country.

These critical and permanent interconnections mean that the United States cannot be indifferent to the course of Mexican economic and political development. The United States has a deep interest in a stable and prosperous Mexico, while a Mexico rent by economic and political discontent would pose a potent challenge to our own security and prosperity.

Today, Mexico is in the midst of a painful and wrenching economic crisis. After years of economic success, the Mexican economy entered a period of stagnation during the 1980's which has produced a virtual standstill in economic growth and a sharp decline

[1] Abraham Lowenthal, "Partners in Conflict: The United States and Latin America," Baltimore, Johns Hopkins Press, 1987, p. 60.

in per-capita consumption. Economic distress has produced a flight capital from the country, and encouraged outward migration, developments which challenge the legitimacy of the ruling Institutionalized Revolutionary Party [PRI].

The government has reacted to this crisis by undertaking a thoroughgoing reform of both economic policy and political institutions, moving toward a greater reliance on decentralized market forces and increased political participation after years of centralized economic planning and oligarchic political rule.

The success and permanence of these changes is uncertain. Mexican gross domestic product [GDP] has not grown appreciably during the 1980's, and the economic policies now in place will in all probability produce another downturn in the Mexican economy in the short term. While such a downturn is seen as necessary to lay the foundations for a future return to stable, noninflationary growth, it is quite possible that the distress caused by current policies will force an abandonment of these policies before they have borne fruit.

Uncertainty about Mexico's future has been enhanced by the outcome of the recent presidential election, in which the PRI candidate received the smallest margin of victory in the party's history, and lost badly in the country's major urban centers. The size of the vote for Cuauhtemoc Cardenas poses a particularly significant challenge to the current economic policy. Cardenas articulated a far more fundamental critique of current administration economic policies than did the other opposition party, the Party of National Action [PAN], and the fact that Cardenas received the largest share of opposition votes among the urban middle class is evidence of profound disillusionment with the social costs of current economic policies.

These developments have been widely reported and analyzed by authorities inside and outside Mexico. While few are predicting a collapse of the current government, this is clearly a time of immense change in Mexico. It is profoundly in the self-interest of both countries to have Mexico succeed in its current economic reforms and return to a pattern of strong domestic growth. Over the past six years, formal employment in Mexico has been virtually stagnant, while the labor force has grown by over 8 million. This has created both serious social problems in Mexico and pressure on Mexican citizens to migrate to the United States in search of work. Rapid labor force growth is projected to continue for the next decade, meaning that Mexico must achieve sustained growth rates of over 4 percent per year in order to make any meaningful progress on the employment front.

Other direct United States interests also would be well served by a resumption of growth in Mexico. Mexico is a market of over 80 million people which is dependent on United States sources for many of its basic import needs. Removing import barriers has been a major policy accomplishment of the present Mexican government, but the strong growth in U.S. exports which such market-opening ought to produce has been retarded by the declines in the purchasing power of Mexican workers. Renewed growth in Mexico means renewed growth in United States exports to Mexico.

But achieving sustained, noninflationary growth in Mexico in the current circumstances will be a difficult undertaking, and Mexico will need the cooperation of the United States in order to make such growth a reality. Mexico's large external debt burden is a major drain on the country's resources, and a principal source of inflationary pressure. The United States has recently supported some initiatives to reduce the size of this debt burden, but there is little doubt that more effective and lasting solutions to the Mexican debt problem will be needed in the coming months. If mutually negotiated solutions are not forthcoming, there is the danger that Mexico will seek unilateral and potentially confrontational ways of responding to its debt problem.

Trade is the other area where the United States-Mexican cooperation will be needed in the months ahead. Without sufficient internal growth, Mexico could become a significant trade problem for the United States, as it cuts imports and expands exports. In the presence of adequate internal growth, however, an expansion of trade between the two countries could provide benefits to both. This type of expanded trade will, however, require skillful resolution of a wide range of trade disputes between the countries. The prospects for such resolution have been markedly improved with the recent signing of a "framework agreement" on trade by the two countries, and the task now is to use the new negotiating framework to discover mutually advantageous deals on trade which balance the interests of both countries.

Over the longer term, attention is likely to focus on the potential for even closer trade ties between the two countries. While the idea of a "North American free trade area" encompasssing Canada, Mexico and the United States is very remote at the present time, it is likely that a considerable amount of attention in both countries will be devoted to evaluating the potential for such an arrangement in the years ahead.

II. ECONOMIC POLICY IN MEXICO

For much of its modern history, Mexico has been regarded as a model of both political stability and economic success. Since the revolution in 1917, civilian Presidents have served out their single six-year terms (known as "sexenios") and been replaced through orderly elections managed by the PRI. Economic progress during the first part of this century was slow but steady, with GDP growth exceeding the growth in population, producing a modest 0.7 percent per year average rise in per-capita GDP.

But as Table I shows, Mexico experienced a sharp increase in its growth rates during the "sexenios" which followed the Second World War.

TABLE I

Period	President	Per capita GDP growth
1947–52	Miguel Aleman	3.5
1953–58	Adolfo Ruiz Cortines	3.2
1959–64	Adolfo López Mateos	4.0
1965–70	Gustavo Díaz Ordaz	3.4
1971–76	Luis Echeverría	2.7
1977–82	José López Portillo	3.1
1983–88	Miguel De La Madrid	−2.5

Source: Banco De Mexico; Dornbusch.

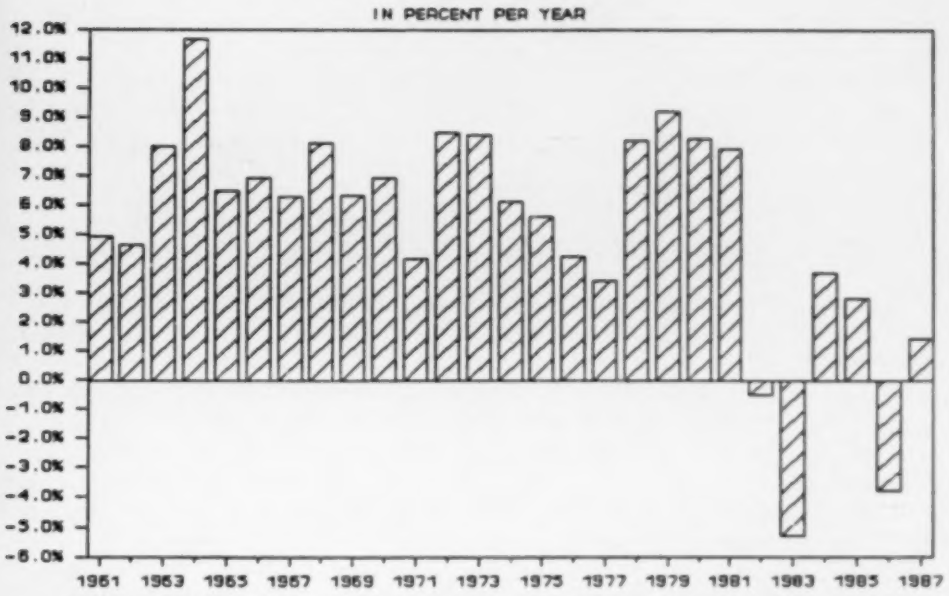
During the war, a worldwide shortage of goods of all types forced Mexican officials to stimulate the domestic production of a wide range of manufactured goods. The resulting boom in economic activity resulted in the adoption of import substitution as a national development strategy once the war ended. Protective barriers were raised against imports, and government subsidies and incentives were applied extensively to promote the growth of local industrial firms.

The ERA of "Stabilizing Development"

Mexico's success with "import substituting industralization" (ISI) made it the envy of much of the developing world. Overall GDP growth averaged 6 percent, while per-capita GDP soared at an average of 3.1 percent per year during the entire period between 1940 and 1980. As Figure 1 demonstrates, one of the more remarkable features of this period was the lack of a single year of negative GDP growth from the end of the War to the start of the 1980's.

Figure 1

REAL GDP GROWTH



Real investment grew at a 10 percent annual average rate, composed of 60 percent private investment and 40 percent government investment. Investment rose from 17 percent of GDP in 1954 to 19.6 percent by 1970. Domestic prices remained remarkably stable by Third World standards during this period, averaging an increase of only 3.8 percent per year, in large part due to the policy of fixed exchange rates between the peso and the U.S. dollar. Because of its tremendous success, this period is known in Mexico as the era of "stabilizing development."

Despite its apparent successes, the era of "stabilizing development" also built up tensions in Mexican society. The protection granted domestic Mexican industry produced a rapid rise in industrial production, but also produced an industrial structure which was inefficient and uncompetitive by international standards and excessively dependent upon the government. At the same time, government economic policy focused almost entirely on industrialization and supporting local businessmen, while often neglecting the economic and social needs of the majority of workers and small peasant farmers. Agricultural performance deteriorated and the distribution of income worsened substantially as Mexico's protected industrialization progressed.

Rural discontent with the economics of the ISI strategy was eventually combined with urban discontent with the relatively closed political system which implemented this strategy. The urban middle classes, themselves largely a product of the ISI strategy, eventually came to demand greater openness and participation in the political process.

These separate threads of discontent came together in dramatic fashion in 1968, when student demonstrations in Mexico City in anticipation of the forthcoming Olympic games were joined by the disaffected urban middle class. The army opened fire on one group, killing a number of demonstrators and precipitating a major political crisis for the regime.

The immediate aftermath of the 1968 riots was a period of calm and repression, but the PRI had been badly shaken by the size and scope of the demonstrations. In 1970 a new President, Luis Echeverría, was sworn in and quickly began a process of reforming Mexican economic policies.

From Stabilizing Development to Shared Development

Echeverría interpreted the 1968 disturbances as a reaction to the uneven and imbalanced character of Mexican economic development. Rather than alter the fundamentals of the strategy, however, Echeverría elected to add a new element—massive public spending designed to mitigate the inequalities which the strategy produced. Under Echeverría, social welfare programs of all types expanded, as did the scope of public sector subsidies on critical mass consumption items. As a result of these efforts, public expenditures expanded from 20 percent of GDP in 1970 to 33 percent by 1980.

This new model of public sector redistribution was termed "shared development." In essence, "shared development" was layered a redistributive public sector on top of an inefficient and protected private sector. This tended to create inflationary pressures, since the additional aggregate demand created by public sector spending was not matched by equivalent increases in the supply of goods from the private sector.

The inflation problem was worsened by the government's reliance on deficit financing to sustain expanding public budgets. Initially, the government raised taxes to support the increased spending called for by the new strategy, but spending rose far faster than did tax revenues and the government turned to borrowing as its principal method of finance. The public sector fiscal deficit rose from 2 percent of GDP in 1971 to nearly 9 percent in 1975, helping to fuel an increase in inflation from 4 percent during the 1960's to over 20 percent in 1974 and 1975.

At the same time, "shared development" began to affect the country's external accounts, as the surge in domestic demand pulled a flood of imports into the country. Mexico's industrial sector, shielded from competition for years behind protective barriers, was incapable of generating sufficient exports to pay for the flow of imports. Furthermore, the country's external problems were compounded by a fixed exchange rate, which grew progressively more overvalued as Mexican inflation proceeded at a more rapid pace than inflation in its trading partners. As a result, the nation's current account deficit steadily deteriorated, growing from 1.9 percent of GDP in 1970 to 3.3 percent in 1975.

These developments set the stage for a series of macroeconomic "stabilization crises" which became the dominant economic problem for the country in the late 1970's and early 1980's.

III. STABILIZATION CRISES: MEXICO'S MACROECONOMY IN THE 1970'S AND 1980'S

By 1976, the Mexican economy had reached the limits of the "shared development" strategy based on domestic fiscal expansion. Increasing domestic inflation, deteriorating external accounts and soaring fiscal deficits convinced many wealthy Mexicans that a crisis was imminent and that the peso would have to be devalued. On the basis of this calculation, wealthy Mexicans began shifting their assets out of pesos and into dollars, putting pressure on central bank reserves and creating the necessary preconditions for devaluation.

In August of 1976, at the very end of his sexenio, Echeverría acknowledged the failure of economic policy by announcing a nearly 100 percent devaluation of the peso and imposing extensive import controls to stem the deterioration in the country's external accounts. His successor, López Portillo, was given the unenviable task of starting his presidential term with the need to impose painful austerity upon an economy accustomed to rapid growth.

The new administration reacted to the crisis in a surprisingly orthodox fashion. Despite the emphasis of "shared development" on income distribution and spreading the benefits of growth widely, López Portillo negotiated with the International Monetary Fund (IMF) what amounted to an "orthodox" austerity program. The plan called for cutting the federal deficit, devaluing the currency, maintaining high interest rates and tightening credit to control inflation and capital flight. In its planning, the government anticipated zero economic growth for all of 1977 as the contractionary influences of this policy worked their way through the economy.

The program proved far less painful than had originally been imagined. The fiscal deficit was cut from 9.9 percent of GDP to 5.3 percent, and the current account deficit fell by a hefty $2 billion during the year, but economic growth fell only modestly (to 3.4 percent from 4.3 percent), far less than had been predicted. Inflation declined modestly, but remained above 20 percent, a level sufficient to raise questions about the depth and sustainability of the stabilization efforts.

Whether the government would have proceeded further with fiscal consolidation and external account adjustment will never be known, since the stabilization package put in place during 1977 was rendered irrelevant by the enormous oil reserves discovered off Mexico, whose size was fully revealed to the public during 1978.

The adjustments initiated in 1977 were quickly abandoned once the oil boom started. To some extent, this reaction was logical, since the discovery of massive oil reserves appeared to solve the two basic problems of fiscal deficits and external payments imbalances. Oil would provide strong export earnings and thus shore up the peso and strengthen the country's external accounts. And oil

income would also fix the deficits in the public sector, since PEMEX was a state-owned industry whose profits fed directly into the government's income stream.

On the strength of anticipated oil earnings, the government quickly shifted its focus from austerity to growth. The IMF austerity plan was abandoned, and a new "industrial development plan" was prepared which set a goal of 10 percent annual growth rates for GDP, and envisioned, once again, that the federal government would play the role of leading sector. Backed by this optimistic plan, real public spending rose from 29.5 percent of GDP in 1978 to 41.6 percent in 1981—fully 8 percentage points above the peak recorded during the Echeverría administration.[1]

Oil and Debt

Oil also brought about a major change in Mexico's relationship with external capital markets. Prior to the oil boom, Mexico was able to secure moderate amounts of financing from international banks and capital markets, but external finance had never played a central role in fostering the country's economic development. But high oil prices, and massive cash surpluses in the OPEC countries of the Middle East, created incentives for international banks to lend money to apparently credit-worthy developing countries such as Mexico.

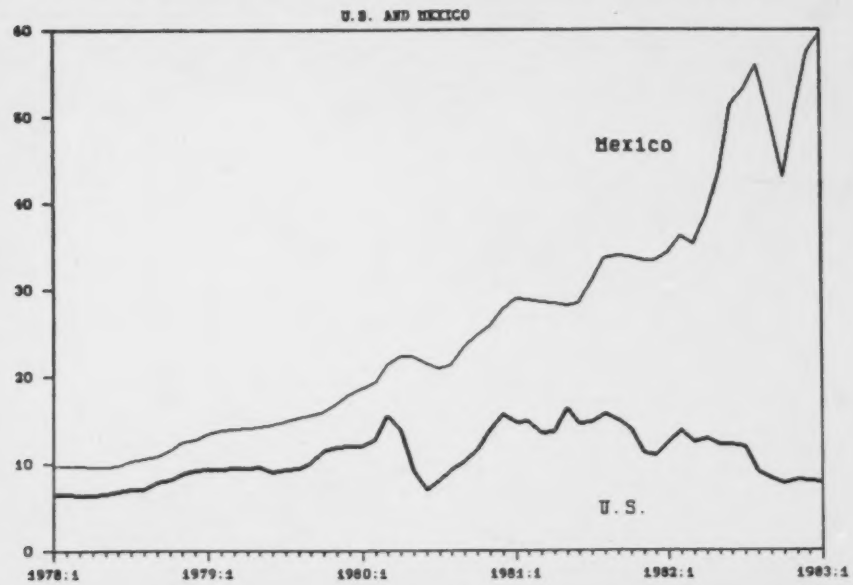
In this new international environment, both the public and private sectors in Mexico sought to take advantage of the easy availability of foreign credit. The government borrowed heavily to finance expansion of PEMEX and other para-statal enterprises, while the private sector turned from domestic to international sources of financing. For both the public and private sectors, external borrowing was cheaper than raising funds in local credit markets, for, as Figure 2 shows, interest rates in the United States remained substantially lower than interest rates in Mexico throughout the late 1970's. As long as oil exports were seen as protecting borrowers from exchange rate depreciation, foreign borrowing was the logical choice for a rational Mexican investor.

---

[1] Edward Buffie and Allen Sangines Krause, "Economic Policy and Foreign Debt in Mexico," in Jeffrey Sachs, ed. *Developing Country Debt*, National Bureau of Economic Research, 1987.

Figure 2

INTEREST RATES ON SHORT-TERM BORROWING



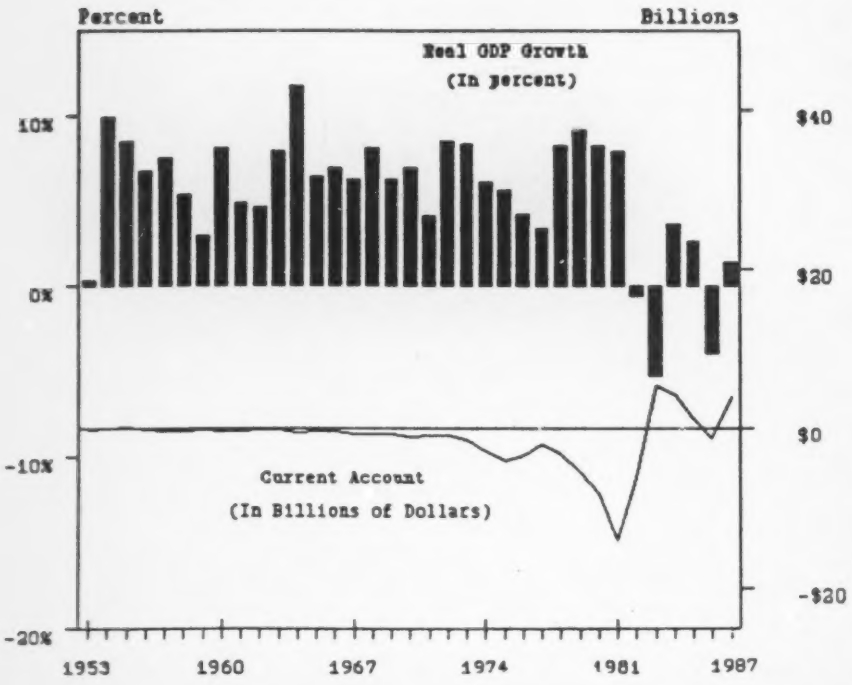
Unfortunately for Mexico, the ready availability of foreign capital made it easy to ignore the structural problems in the Mexican economy which had precipitated the 1976 crisis. Driven by sharp increases in public spending, the fiscal deficit rose from 5.4 percent of GDP in 1978 to an unprecedented 12.2 percent in 1981. This large increase in demand was not matched by an equivalent increase in domestic output, and imports exploded to fill the gap. This increase in imports was facilitated by an exchange rate policy which permitted appreciation of the real peso exchange rate of more than 35 percent between 1977 and 1981.[2]

As Figure 3 shows, Mexico during the late 1970's managed to maintain impressive rates of GDP growth, but purchased that growth largely by running very large deficits in its current account—deficits which were financed by the ready availability of external debt financing.

[2] Appreciation of the real exchange rate was produced by freezing the nominal exchange rate between the peso and the U.S. dollar during a period when Mexican prices were rising substantially faster than United States prices. This defense of a fixed exchange rate in the face of differential inflation rates has remained a central theme in Mexican exchange rate policy.

Figure 3

ECONOMIC GROWTH AND THE CURRENT ACCOUNT

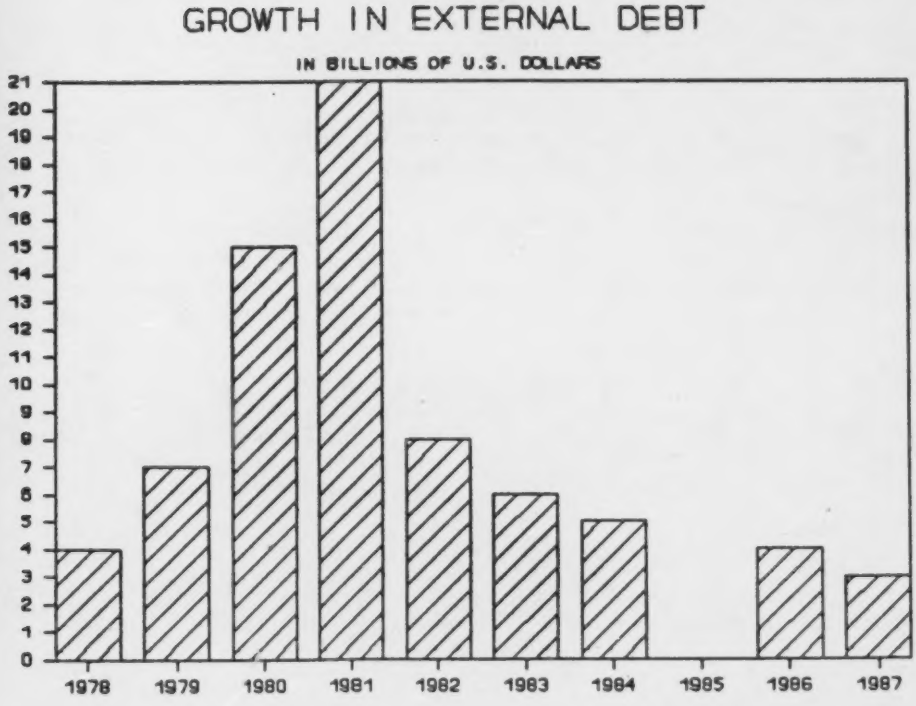


The scale of Mexico's borrowing during this period was breathtaking. During the late 1970's and early 1980's, bank lenders competed fiercely with one another to loan money to Mexico. Nine of the fifteen largest U.S. money center banks extended loans to Mexico which amounted to 40 percent of their combined capital and reserves. Much of this lending was on terms very favorable to the borrower, with interest rates only slightly above the banks' own cost of funds.

International bankers were aware of the deterioration in Mexico's underlying economic performance, yet they continued their generous lending policies toward the country. As Figure 4 shows, new loans to Mexico shot upward in 1981 at the very time that economic performance was deteriorating most sharply. A recent study of bank lending to Mexico questioned this peculiar pattern, and concluded that: ". . . decision makers at leading banks in loan syndications were ignoring the trends and implications revealed by country risk analsysis." [3]

[3] Jeffrey Brannon and David Schauer, "Country Risk Assessment and U.S. Banks: The Case of Mexico," *Texas Business Review*, vol. 57, July-August 1983, p. 195.

Figure 4



Given Mexico's large population, abundant natural resources and relatively developed industrial structure, the huge borrowings documented in Figure 4 were not necessarily evidence of economic mismanagement. Heavy external borrowing was part of the economic history of such countries as the United States, Canada, Australia and South Korea during similar periods of their own history, and at the time many thought that Mexico was simply following the successful strategy of borrowing to finance rapid building of its capital investment base.

Unfortunately, as a recent study points out, Mexico did not put its borrowings to productive use.

> The overly rapid accumulation of foreign debt by the López Portillo administration would not have inflicted lasting damage on the economy had the funds been used to finance efficient investment projects. Unfortunately, this did not happen. According to various estimates, roughly one-half of the debt accumulated during this period financed capital flight. Almost all of the remaining debt was absorbed by payments on previously contracted debt. . . . After making due allowance for capital flight, the splurge in government consumption and inefficient investments by the para-statal sector, it is difficult to escape the conclusion that Mexico obtained remarkably little for the $66 billion of debt taken out during the López Portillo years. Per-

haps the best evidence in support of this conclusion is provided by the extreme hardship the economy has subsequently suffered in servicing the debt.[4]

Two factors are particularly important in explaining the low productivity of much of this new external debt: inefficiency and capital flight. Much of the new money pouring into the country was destined for public or para-statal entities, particularly those in the "prestige" areas of petroleum, steel and heavy industry. Not only were such investments economically inefficient, they also provided opportunities for diversion into the pockets of public officials or to political patronage.[5]

In the private sector, much of the new borrowing was "recycled" by sending it back to the United States or other hard-currency countries in the form of bank accounts or real estate investments. The large external borrowings gave Mexican investors access to dollars or other hard currencies, while the persistence of such problems as inflation, budget and trade deficits gave them a reason to "hedge their bets" by accumulating resources outside of Mexico. As Table II shows, estimates of capital flight vary widely, but all show substantial outward movement of funds, particularly prior to the crisis of 1976 and the much larger crisis of 1982. By many accounts, between half and two thirds of the new borrowings taken on during the late 1970's ended up as flight capital.

TABLE II.—ESTIMATES OF CAPITAL FLIGHT

[In billions of U.S. dollars]

	1976–79	1980–82	1983–84
Morgan Guaranty	13.1	22.5	17.7
Cuddington	5.9	23.4	6.9
Zedillo	3.9	17.3	4.6

Source: Lessard and Williamson, Capital Flight and Third World Debt, 1987.

These factors help to explain a part of Mexico's debt problem, but they do not convey the full picture. Many of Mexico's investment projects, financed with borrowed money, were based on assumptions of continued worldwide price inflation and continued strong growth in Mexico. When those conditions did not materialize, much of Mexican industry was saddled with a large problem of excess capacity. In the new environment of excess capacity and stagnant overall growth, investments which at the time looked rational now appeared "wasteful." It is thus not an easy task to determine how much of the foreign-financed investment was initially uneconomic, and how much has been made uneconomic by subsequent events.[6]

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[4] Buffie and Krause, *op. cit.*, p. 155.

[5] In his thougthful book on Mexico, journalist Alan Riding noted: "In essence, the economy grew too fast and the government spent too much. Since oil revenues were insufficient to finance the boom, the government resorted to printing pesos and borrowing dollars to finance its swelling public sector deficit. In the absence of adequate controls, both corruption and waste proliferated, typical signs of 'financial indigestion.'" Alan Riding, *Distant Neighbors*, New York, Random House, 1984, p. 213.

[6] This observation was suggested by Professor Albert Fishlow of the University of California, in comments on an earlier draft of this paper.

1982: The Second Stabilization Crisis

The pattern of using external borrowing to mask structural inefficiencies in the domestic economy could not be sustained indefinitely, and the "borrow and spend" policies of the López Portillo administration soon began to run into difficulties.

The heavy external borrowing put Mexico increasingly at the mercy of world macroeconomic developments. The American back-to-back recessions of 1979 and 1981 put an increasing burden on Mexico's economy. World interest rates (used to determine Mexico's debt-service obligations) rose substantially in the wake of the Federal Reserve's decision to use tight monetary policy as a device to fight inflation. But inflation had been one of the strong factors helping Mexico borrow in international markets, since many of its exports, including oil and silver, benefited from the general boom in commodity prices which accompanied high inflation. When tight money and the deep 1981 recession brought inflation down dramatically, Mexico's export earnings and international credit-worthiness both plummeted.

The rise in interest rates starting in 1979 helped contribute to the massive deterioration of the current account shown in Figure 3. This, in turn, convinced many Mexican investors that a devaluation of the currency was imminent, accelerating the flight of capital from the country, which had to be covered by still more public sector borrowing.

Early in 1981, the government put forward a package of "reforms" aimed at eliminating some of the most visible problems. Government expenditures were targeted for a 4 percent reduction, import licenses were introduced on a broad range of products to help stem the tide of imports, and prices of key public goods such as gasoline were raised significantly. As in 1976, the Mexican response to a macroeconomic crisis was to adopt many of the measures which prevailing economic theory suggested were the appropriate cures for the problem.

These reforms were, however, a case of "too little to late." The fiscal deficit fell modestly, from 8.3 percent of GDP in 1980 to 7.9 percent in 1981, but imports surged and the current account deficit soared, going from $8 billion in 1980 to a staggering $14 billion in 1981.

Faced with this sharp deterioration in its external accounts, the government in February of 1982 took the inevitable step of devaluing the currency, letting the peso "float" to its market-clearing level. The currency immediately dropped 67 percent, producing an inflationary shock to the economy as import prices immediately soared in response. To help control domestic prices, the government in March announced a new anti-inflation program, one also based largely on the 1976 IMF prescriptions of deficit reduction and monetary tightening, combined with traditional Mexican policies of price controls on key commodities and quantitative restraints on imports.

Although much of the announced program was not actually implemented, the deteriorating external environment helped drive the Mexican economy into a deep recession, with real GDP falling by over 5 percent in 1982, the deepest slump in Mexican history.

Depreciation and import controls produced a drastic drop in imports, which fell by nearly 50 percent from their 1981 levels. Despite the slump, prices continued to climb, with the yearly inflation rate for 1982 soaring to 99 percent, an all-time high.

But the 1982 crisis also had the new element of massive external debt. In 1976, the nation's external debt to GDP ratio stood at 13 percent, but the extensive borrowing during the López Portillo administration had driven that figure to 33.3 percent by 1982. The external debt of some $80 billion required annual debt service payments of $9 billion, which amounted to approximately 34 percent of Mexican exports. Even more disturbing was the fact that Mexico's international bankers reacted to the rapid run-up in international interest rates by shortening the maturities on loans made to Mexico. By 1982, close to one-third of Mexico's total external debt was due within a year.

Faced with falling commodity prices, rising interest costs, and a legal requirement to repay or refinance one-third of the principal, Mexico found itself in an untenable position, and in August 1982, inaugurated the "international debt crisis" by declaring itself unable to meet its obligations. To control the flight of capital which such an announcement generated, the government also mandated that dollar accounts maintained in Mexico would be automatically converted into pesos at the new devalued exchange rate—forcing significant losses on holders of "Mexi-dollar" deposits. A few weeks later, as virtually the last act of the outgoing López Portillo administration, the government nationalized the private banking system.

Even though the new President, Miguel de la Madrid, did not repudiate his predecessor's nationalization of the banks, his new administration sought to reassure both international creditors and domestic business interests. The loss of domestic business confidence following bank nationalization was particularly problematic, for the specter of increased state control of the economy caused firms to cut back on investment plans, further depressing economic activity.[7]

To restore confidence, Mexico agreed to an IMF stabilization program which involved the familiar painful remedies of cutting public sector subsidies, raising the prices of public sector goods, and restricting the expansion of credit to cool down the economy. As one recent article put it:

> President de la Madrid, . . . took immediate charge with a firm hand, a sobering inaugural address, and the initiation of a series of measures that proved that he had been busy in his silent period. His new cabinet of technicians and economic conservatives buoyed confidence. An austerity program involving budget cuts, new taxes, price increases, reduced subsidies, and relaxation of foreign exchange controls in several instances reversed measures adopted only months earlier.[8]

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[7] Riding, *op cit.*, p. 126.

[8] Penelope Hartland-Thurnberg and Charles K. Ebinger, "Mexico's Economic Anguish," in Hartland-Thurnberg and Ebinger, *Banks, Petrodollars and Sovereign Debtors*, Lexington Books, 1986, p. 65.

The administration's new "Programa Imediato de Reordenacion Economico" was seen by many international authorities as a model of fiscal adjustment. It promised to cut the budget deficit from 18 percent of GDP in 1982 to 8.5 percent in 1983, 5.5 percent in 1984 and 3.5 percent in 1985, and even took the unprecedented step of cutting the budget of the important energy sector. This draconian program of deficit reduction was rewarded by a prompt rescheduling of Mexico's debt (albeit at very high interest rates) and the infusion of new lending from public authorities and multilateral institutions.

Proof that the government was serious in its embrace of orthodox austerity measures came swiftly. The deficit dropped to 8.7 percent of GDP for 1983, very close to the target, and the trade surplus reached $13.3 billion, with a current account surplus of $4.9 billion. Inflation came down to 80 percent from the 117 percent rate prevailing at the start of the reform. But the price of these successes was steep, with GDP falling 4.5 percent, and real purchasing power falling by some 30 to 50 percent for a majority of Mexicans.[9]

Important compression and the drastic curtailment of domestic demand had an immediate and profoundly depressing effect on investment, whose sharp decline is shown in Figure 5. Firms were unable to obtain the foreign exchange or domestic credit needed to purchase capital goods imports required for expanding domestic production, and, along with the decline in the domestic market, these factors helped push Mexico into a descending spiral of low-growth and low-investment.[10]

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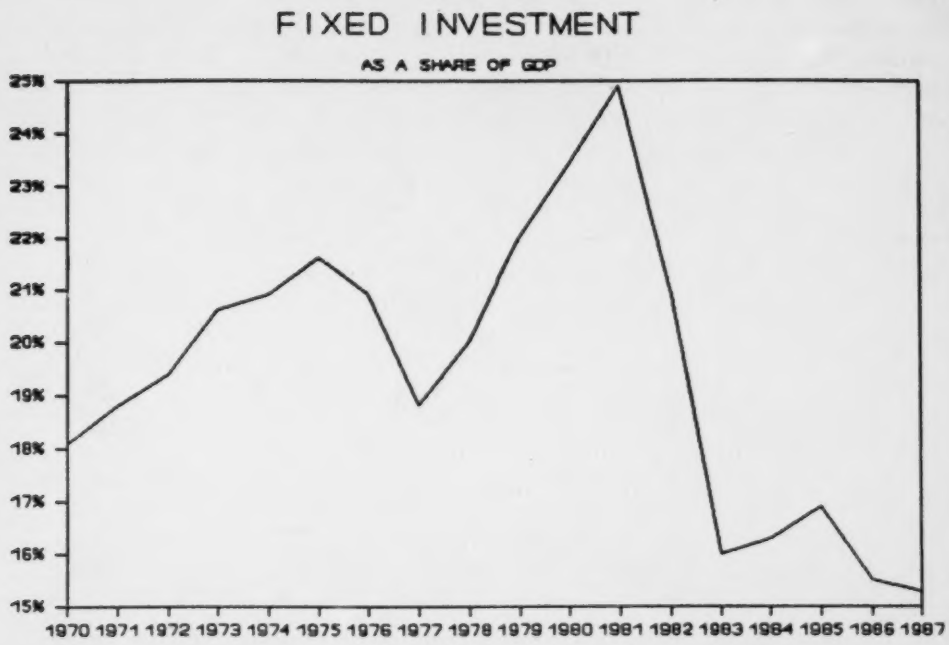
[9] Hartland-Thurnberg and Ebinger, *op cit.*, p. 70.

[10] According to Buffie and Krause: "Import compression has been one of the critical, causal factors underlying the post-1982 slide into low growth, declining real wages and worsening underemployment." *Op cit.*, p. 161.

Figure 5



At the time, it was anticipated that the stabilization program would have only a moderately depressing effect on the economy. Planners anticipated zero growth in real GDP during 1983, but a rise of 3 percent in 1984 and a robust 6 percent rise was forecast for 1985. The "shock," though dramatic, was thus seen as a temporary correction or route to renewed faster growth.

The Unwinding of the Second Orthodox Shock

During 1982 and 1983, the Mexican economy made impressive progress toward the goal of macroeconomic stabilization. Budget deficits were cut, credit expansion was restrained, and incomes fell sharply as economic activity contracted. The rate of inflation started to decline, the stock market boomed, and the trade balance turned sharply into surplus. International creditors were sufficiently impressed with Mexico's adjustment efforts to arrange a $3.8 billion "new money package" for the country early in 1984.

Unfortunately, the momentum of 1982 and 1983 was not sustained, and during 1984 and 1985 the macroeconomic situation in Mexico once again deteriorated. Federal spending expanded, as did the deficit, while monetary policy was eased. The results were a modest return to growth—3.6 percent for 1984, 2.6 percent for 1985—but it was growth purchased at a high price. The current account began to deteriorate, and inflation soared as increased deficits fueled the residual inflation left over from the earlier sharp foreign exchange devaluations.

A major reason for the shift toward increased public spending was growing popular unrest, reflected in a series of opposition party victories in state and municipal elections during 1983 and 1984. Public spending was further expanded in 1985, when a massive earthquake struck Mexico City, causing substantial loss of life and extensive property damage. The public spending needed to rebuild damaged housing and relocate the earthquake victims was an essential to maintaining social peace, but it severely affected the fiscal accounts of the country.

1986: The Third Stabilization Crisis

Following close on the heels of the devastating earthquake, Mexico experienced a new external shock when oil prices skidded dramatically during 1986. The collapse of the oil price (shown in Figure 6) cost Mexico some 6.6 percent of GDP in lost revenues during 1986, forcing the fiscal deficit to an all-time high of 16 percent of GDP, and pushing the current account back into deficit after three years of surplus.

Figure 6

To cope with this new external shock, Mexico turned to the international financial community and, with United States help, persuaded its bankers to extend some $7 billion new loans to help the country adjust to the falling oil price. In return for this new assistance, Mexico pledged to renew its commitment to austerity, adopting a third macroeconomic stabilization package of deficit reduction and monetary tightening which helped reduce real GDP by nearly 4 percent in 1986.[11]

But the 1986 crisis also added a new element to traditional approaches to macroeconomic stabilization. After years of dealing with inflation primarily as a problem of excessive demand, to be controlled with domestic austerity, Mexican leaders began to experiment with policy reforms designed to eliminate structural rigidities in the economy in order to increase the nation's ability to expand supply more quickly and efficiently.

Three elements were central to this structural reform agenda: reducing public sector business subsidies, reducing trade protection for Mexican industry, and increasing the pace of "privatization" of public sector entities. The new commitment to trade liberalization was signaled most dramatically by Mexico's decision to join the General Agreement on Tariffs and Trade [GATT], a move which had been urged on the government for several years but which was previously deemed too unpopular to undertake.

[11] In 1986, however, "orthodoxy" had been significantly redefined, with the IMF permitting Mexico a more liberal method for determining fiscal deficts and granting Mexico some protection against falling oil prices or lagging growth.

IV. THE DOMESTIC LEGACY OF AUSTERITY

The pattern of austerity—inflation—austerity which has characterized most of the last decade has exacted a high price in terms of the living standards of the majority of Mexico's people. The virtual stagnation of the economy since 1980 has been a particular hardship to Mexico's working population. Mexico has an extraordinarily bottom-heavy age profile, and as a result is in the middle of a strong expansion of the working-age population as its youngest age cohorts come of age.

By most estimates, Mexico during the 1980's needed to find productive employment for some 800,000 to 1 million new workers each year. Instead, employment levels in manufacturing (the sector of the economy with the best statistics on employment) fell by 14 percent from the levels recorded in 1981, and some estimate that 400,000 jobs may have disappeared since 1980, while the working population has expanded by 8 million.[1] Although "open unemployment" as recorded by the government has not increased markedly, the deteriorating economy has left a residue of "disguised unemployment" or underemployment which by some estimates amounts to 40 percent of the potential labor force.[2]

Even when lucky enough to find regular work, much of Mexico's labor force has had to contend with a significant fall in real wages. Figure 7 shows a 40 percent decline in average real wages in manufacturing between 1982 and 1987. As in many other developing countries, workers in the manufacturing sector are paid somewhat better than average, and the real value of the minimum wage, which many Mexican workers in the private sector earn, has fallen by more than 50 percent during the same period.

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[1] *Christian Science Monitor*, July 7, 1988.

[2] Riding, *op. cit.*, p. 40; U.S. Embassy in Mexico Foreign Investment Climate Report, March 1988, p. 22.

Figure 7

But these official figures actually understate the decline in living standards for average Mexicans since the prices of key necessities have risen far faster than the general price index used to determine "real" wage levels. The official price index multiplied by 13.8 times between 1981 and 1987, but the price of bread rose by 24 times during the same period, the price of tortillas rose 17.4 times, telephone service rose 20 times, diesel rose by 43 times and kerosene rose 93 times.[3] Most of these changes were due to the elimination of government subsidies on key commodities as part of the general process of fiscal consolidation.

This pattern of employment and wage deterioration has also helped exacerbate the already severe problem of inequality in the distribution of income. In a recent study, Professor Rudiger Dornbusch noted:

> Since employment growth is the main channel through which income distribution is improved, as Chenery has shown, there is little doubt that distribution has worsened over the 1980's. The deterioration of income distribution presents a significant threat to political stability and limits the range of options for stabilization and growth.[4]

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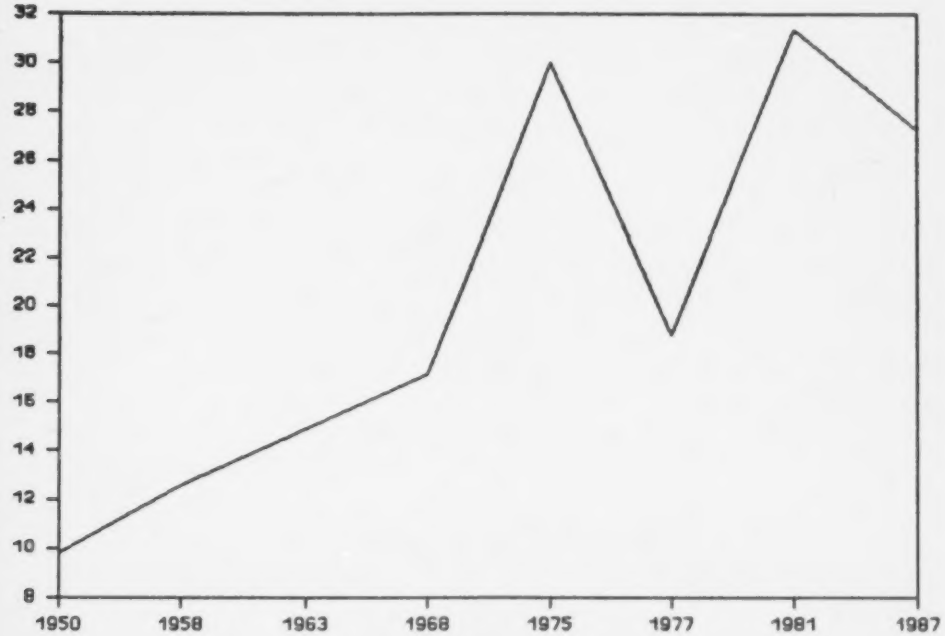
[3] Luis Rubio, "A Second Revolution Advances on Mexico," *Los Angeles Times*, June 24, 1988.
[4] Rudiger Dornsbusch, "Mexico: Stabilization, Debt and Growth," Massachusetts Institute of Technology, unpublished manuscript, July 1988, p. 7.

Available statistics on income distribution bear out this impression. Official studies on income distribution have not been done since 1977, when official statistics showed the richest 20 percent of the population controlling 54.5 percent of the income, while the poorest 20 percent claiming only 2.9 percent. This gave Mexico one of the most extreme income distributions among middle-income developing countries.

Private surveys suggest the problem may be even more acute. Recent research by the Banco Nacional de Mexico, shown in Figure 8, suggests that the 1977 data may significantly understate the extent of income inequality, since other data series before and after the 1977 survey show a steady trend toward growing inequality between the top and the bottom of Mexican society.[5]

Figure 8

INDEX OF INCOME INEQUALITY



Source: Banamex

This trend has troubling implications for the future, as noted by a former advisor to President Echeverría:

> Government statisticians predict that although by the turn of the century 30 million Mexicans will have work, only 21 million will earn minimal levels of income. The technocrats unspoken assumption is that Mexico's economy will have to retain low wages and a high concentration

[5] The index used in the graph divides the share of income going to the top quintile of families by the share going to the bottom quintile.

> of wealth. The hope is that high and consistent growth rates of 4 or 5 percent per year eventually will integrate those waiting in line. To make employment and income distribution the immediate goals of modernization is seen not only as futile but as seriously jeopardizing capital accumulation, efficiency and technological assimilation.[6]

This economic distress has generated considerable popular discontent with current policies. A poll taken in November 1986 found that 61 percent predicted further economic deterioration, and 54 percent believed Mexico would never come out of its crisis. In a similar poll, taken in December of 1987, 69 percent blamed current economic troubles on misguided government policies, and 55 percent believed that new policies were needed, while only 14 percent felt it was desirable to continue with present approaches to the country's problems.[7]

Newspaper reports suggest that the level of violent crime in Mexico City has recently risen by more than 300 percent, from an already very high base.[8] Drug trafficking is also on the rise in many parts of the country. The weakening of governmental authority produced by years of austerity has opened the way for extensive corruption of political life in many parts of rural Mexico by the "narcotraficantes." For many rural Mexicans, participation in the drug trade is an economic decision driven by difficulties in finding any other form of income.

Yet despite these economic hardships, informed observers are impressed with the stability of Mexico. The Mexican social structure is remarkably resilient and stable, and the "informal economy" has been surprisingly able to provide some employment for new workers even as formal employment stagnates. Observers find surprising acceptance of economic hardship,[9] "phenomenal social discipline," [10] an atmosphere of calm in the poorest urban neighborhoods even after the election,[11] and a turn toward the extended family as a source of economic support in tough times.[12]

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[6] Adolfo Aquilar Zinser, "Mexico: the Presidential Problem," *Foreign Policy*, Winter 1987-1988, p. 45.

[7] Public Opinion survey conducted by Enrique Alduncin Abita for the Banco Nacional De Mexico, unpublished data, December 1987.

[8] Uno Mas Uno, January 19, 1987.

[9] Susan Kaufman Purcell, "Mexico: Crisis but no Collapse," *Orbis*, Winter 1988, p. 59.

[10] Jack Bruton, Executive Vice President, American Chamber of Commerce in Mexico, interview, May 2, 1988.

[11] *Wall Street Journal*, July 28, 1988.

[12] "Our greatest advantage in times of crisis is that most people will go home to help their families, and not into the streets to attack the government." Mexican politician, quoted in *Wall Street Journal*, July 28, 1988.

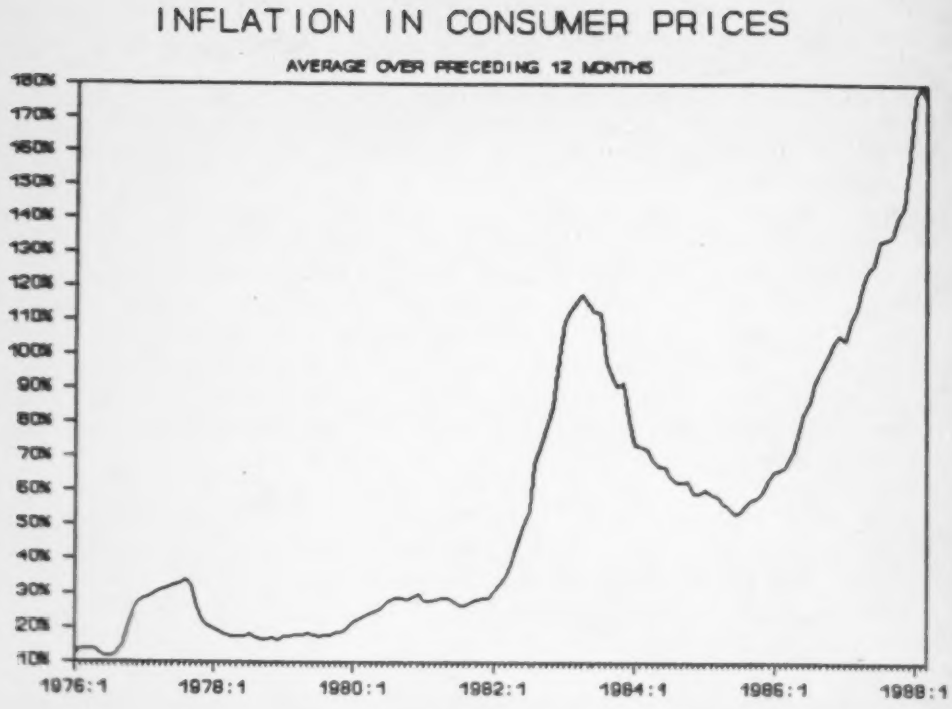
V. 1988: THE FOURTH STABILIZATION CRISIS

After the oil-induced crisis of 1986, many observers of Mexico turned cautiously optimistic on the country's prospects. Oil prices remained depressed, but volume increases helped boost total oil export revenues from $6.3 billion in 1986 to $8.6 billion in 1987. Non-oil exports surged, and the current account shifted sharply from deficit into surplus. Real GDP, which had fallen by 4 percent during 1986, started growing again, turning in a modest 1.4 percent increase for all of 1987. International interest rates, which determined the value of debt service payments, were falling and the country appeared to be on good terms with its creditors following the huge new loan secured during 1986.

But this apparent good health of the Mexican economy was based on weak foundations. The fiscal deficit, which had exploded from 9.9 percent of GDP in 1985 to 16 percent of GDP in 1986, declined only fractionally to 15.8 percent of GDP for 1987. Programmatic outlays of government had been cut from 22.6 percent of GDP in 1986 to 20.4 percent in 1987, but these cuts were more than compensated for by increases in interest payments, which rose from 16.3 percent of GDP to 19.4 percent.

These realities paved the way for a renewed upward movement in inflation, shown in Figure 9, which reached alarming proportions by the end of 1987.

Figure 9



In the midst of this deepening economic crisis, President de la Madrid selected Carlos Salinas de Gortari, the Minister of Planning, to be his successor as the PRI candidate for President in the elections set for July 1988. Salinas had been a major architect of de la Madrid's stabilization policies, and his choice as successor was seen by many as a sign of continued commitment to economic orthodoxy.

Salinas, as Minister of Planning, initially approved a new fiscal budget which called for expanded public spending and more rapid economic growth. But as the monthly inflation accelerated during 1987, Salinas ordered this budget abandoned and directed that a new and far more austere budget be prepared in its place.

The new, austerity-oriented budget, coming in the early months of an electoral campaign, heightened the tensions in Mexican society. Rising inflation and cuts in the budget of the public sector produced increased opposition, and lent weight to talk of a possible general strike in protest of government policy.

To deal with this growing public opposition, the government in the fall of 1987 began a series of closed-door negotiations with representatives of major economic interests in Mexcico. The purpose of these talks was to hammer out a compromise agreement which would satisfy the demands of both efficiency and fairness. In December, these negotiations produced an agreement—Pacto de Solidaridad Economica—known as the "Pacto."

The Pacto

The Pacto, presented as a major new departure in policy, represents largely an effort to put many familiar policy tools together in one package. As economic policy, its principal elements are: a wage and price freeze; fiscal deficit reduction; tight money; import liberalization; and privatization.

The theoretical framework of the pact is the so-called "heterodox shock" plans introduced in 1985–1986 to combat hyperinflation in Argentina (the Austral Plan), Brazil (the Cruzado Plan) and Israel. A variant of these plans was put before the cabinet in later 1985 by Salinas as Planning Minister, but was rejected by de la Madrid.[1] The basic elements of the Pacto are:

Price Freeze.—The centerpiece of the Pacto was an agreement to the "shock" effects of a sweeping price freeze as a device to tame inflation. Goods and services making up roughly half of the "basket" used to compute the consumer price index were frozen immediately, while workers were allowed a 15 percent "emergency" wage increase in mid-December 1987, followed by a planned 20 percent wage increase in January 1988. Thereafter, both prices and wages were to be determined by an ingenious process of *prospective* target-setting. The government would announce *in advance* its target monthly inflation rate and all prices would be capped at that rate of increase.

Although this anticipatory price-setting mechanism had many of the structural elements of "indexation" schemes used in countries with chronic high inflation, the government declared its intention to stick with the freeze (a prospective target of zero), and use any target price adjustments only as a transitional measure toward permanently lower inflation.

Deficit Reduction.—While the price freeze is seen as the critical short-run measure, the long-run success of the Pacto is premised on reducing the federal budget deficit. Overspending by government is seen in Mexico as a root cause for current inflation, and there is substantial determination to reduce fiscal deficits. Immediately prior to the implementation of the Pacto, prices for a broad range of government-supplied goods were raised by an average of 80 percent, and the Pacto itself announced a goal of cutting "programmed" spending from 22 percent of GDP in the prevailing budget to 20.5 percent.

Evidence of a move toward fiscal austerity is apparent in recent statistics on fiscal policy. Because of the distortions introduced into the economy by a large debt burden (both internal and external), and by rapid inflation, Mexican economists usually discuss fiscal policy using three different deficit concepts:

- The *financial* deficit, which measures the total amount of money which the government must borrow to cover all its costs. This is the broadest indicator of government pressure on domestic capital markets, and gives some indication of the financial resources in the economy which are left over for non-governmental purposes once the public sector has financed its own operations.

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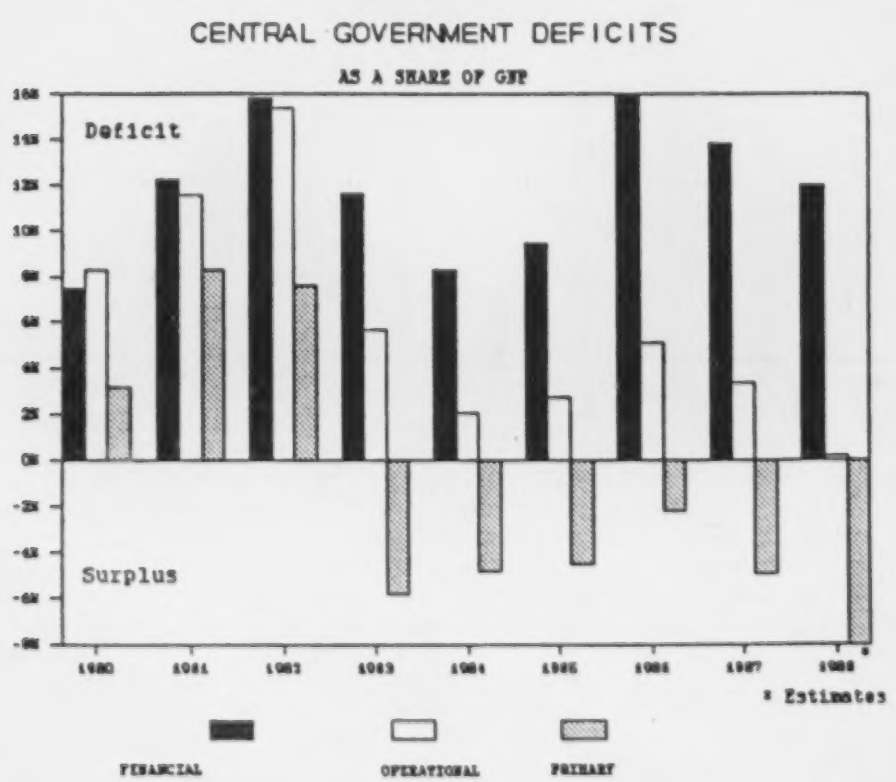
[1] *Financial Times*, February 29, 1988.

- The *primary* deficit, which subtracts interest payments from the financial deficit. This measure provides an indication of how much discipline has been enforced on *discretionary* spending, and is often seen as a good indicator of the government's commitment to spending restraint.
- The *operational adjusted* deficit which corrects the financial deficit for the effects of inflation, largely by subtracting that portion of government interest payments which merely represent a compensation to investors for the losses associated with inflation. This is the measure most favored by economists, since it provides the clearest picture of what the deficit would be if price stabilization policies were effective.

As Figure 10 shows, by any of these measures, fiscal policy in Mexico has moved toward sharp tightening. The "primary surplus" is slated to rise to 8.3 percent of GDP in 1988 from a deficit of 7 percent of GDP in 1982, a swing of nearly 15 percent of GDP, while the operational adjusted deficit should be approximately zero—effectively a balanced budget if inflation were brought under control. But because inflation has been only partly tamed, estimates are for a financial deficit of near 12 percent for 1988.

Figure 10



Despite impressive progress on fiscal consolidation, high real debt service payments continue to put a drain on public finances,

and create conditions where renewed inflation could generate a sharp upward rise in the financial deficit. Progress has been substantial, but the potential for future problems with the deficit cannot be completely ruled out.

Monetary Policy.—As in past stabilization efforts, strict control of money and credit is a key element in the Pacto. Figure 11 shows the abrupt change in interest rates which accompanied the Pacto.

Figure 11

More important than interest rates, however, are government direct controls on the expansion of credit. The Banco de Mexico has the power to impose reserve requirements on commercial banks which effectively allocate credit to the central government and deprive the private sector of credit. Such credit controls have been a familiar feature of Mexican monetary policy, but were imposed with particular force during the stabilization crisis of 1986, relaxed somewhat toward the fall of 1987, then reimposed as part of the Pacto in early 1988. As a result, only approximately 10 percent of new commercial bank deposits were available for lending to the private sector during this entire period.[2]

These policies have resulted in an acute credit shortage in the private sector, a constraint on growth which is eased somewhat by the Mexican business tradition of relying more on retained earnings than on domestic credit markets to finance investment. The

[2] *Financial Times*, December 10, 1987.

credit squeeze also forces firms with access to international sources of funds to turn to such sources for working capital and new investment resources, which in turn helps ease the pressure on central bank reserves. As one observer put it:

> The Government is trying to tell both domestic and multinational companies that, if they wish to do business in Mexico this year, they must either import dollars or dip into their corporate treasuries.[3]

The exchange rate is the third element of monetary policy, and the one most observers watch closely. Under the Pacto, the exchange rate is treated like any other price, and has been frozen along with all other prices in the economy. Until inflation is reduced to the level prevailing in the U.S., however, a fixed nominal exchange rate means an appreciating *real* exchange rate, having the effect of reducing the price of imports and increasing the price of exports. This real exchange rate appreciation plays a role in domestic price stabilization (by lowering import prices) but compromises the goal of export promotion (by raising export prices), and the tension between these two policy objectives has yet to be resolved.

The central bank is taking an empirical approach to the setting of the exchange rate; if foreign exchange continues to flow into the country, the exchange rate is set at an appropriate level.[4] This approach may lead to excessive optimism about the sustainability of the exchange rate, since a good portion of recent capital inflow appears to be driven by either companies pulling in foreign exchange because of the lack of domestic short-term credit, or speculators moving funds into the peso to take advantage of the very high real interest rates. Neither flow necessarily indicates long-run confidence in the currency, and may exacerbate a flight of capital in the future. Such flights of capital have been the undoing of previous economic reforms, and there is concern that the exchange rate may once again be the point of pressure on the current program.[5]

Trade Liberalization.—The fourth key element of the Pacto is a dramatic acceleration of trade liberalization. Mexico has been liberalizing its external trade since 1983, joined the GATT in 1986, and negotiated a "framework agreement" on trade with the United States during 1987. These measures moved Mexican trade policy from a complex system of 16 different tariff schedules with rates as high as 100 percent to a single schedule with a maximum rate of 20 percent. Further trade liberalization plays a key role in the inflation stabilizing policies of the Pacto.

In past stabilization efforts, import licenses were used extensively to stem the flow of imports and slow the deterioration of the trade balance. During 1987, policy shifted toward using the exchange rate to manage import growth, and quantitative import re-

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[3] *Financial Times*, February 29, 1988.

[4] "The exchange rate is where it should be if you're not losing reserves," argues one minister. "If you are, then it's not." *Financial Times*, February 29, 1988.

[5] Rimmer De Vries of Morgan Guaranty Trust noted recently: "In the final analysis, reserve buildup leads to capital flight. Thus I will be very surprised if much less than half of [Mexico's] $12 billion [in central bank reserves] will de facto finance capital flight." Lessard and Williamson, *Capital Flight and Third World Debt*, Institute for International Economics, 1987.

straints have been eliminated entirely on 95 percent of all tariff items (representing 75 percent of trade by value). In fact, low-priced imports are being used as a source of downward pressure on domestic prices, and to put pressure on industries which violate the wage and price freeze. Earlier this year, quantitative restraints on both textiles and pulp were relaxed by the government after both industries were seen to be cheating on the price freeze guidelines.

This drastic liberalization of import restraint is matched in the Pacto with a heavy emphasis on export promotion. Mexico's decision to join the GATT, and the 1986 bilateral understanding with the U.S., have eliminated previous export subsidy programs, but the devaluation of the peso and the tight domestic credit restrictions have been a powerful incentive for Mexican businesses to expand their export sales.[6]

Privatization.—One of the most controversial elements in the new approach is the rapid reduction of size and number of para-statal entities. The de la Madrid administration inherited 1,150 para-statal enterprises, and by the beginning of 1988 had sold 112 of them, mainly in cement, soft drinks, hotels, textiles, car parts, and petrochemicals.[7] Recent reports put the number of para-statals in the process of "disincorporation" at 657, and another 45 are shifting from majority to minority government ownership.[8]

Aggregate statistics tell only part of the story. Over the past year, the government has demonstrated its commitment to privatization in highly visible and symbolic ways. Last year, it elected to close Fundadores Monterrey, a money-losing steel plant which was the centerpiece of government enterprise in the important industrial center of Monterrey. In 1988, the government forced the bankruptcy and restructuring of Aeromexico, the para-statal firm which ran the major internal airline system.

Also in 1988, the government agreed to sell the huge copper mine of Minera Cananea to private investors. The proposed $910 million sale would be the largest privatization in all of Latin America. While the initial arrangement with investors was not completed as scheduled, and the sale remains in limbo at the time of this report, the decision to sell Cananea represents a major government commitment to the idea of privatization. Cananea was the site of 1906 strike often seen as the birthplace of the Mexican labor movement. The fact that the mine was profitable only added to its symbolic importance. As one commentator observed: "Cananea initiated a historical cycle in Mexico. Now, more than 80 years later, it appears to be marking the end of that cycle."[9]

Foreign Investment.—A new approach to foreign investment is also part of the strategy on privatization. Although Mexico has a tradition of resisting foreign dominance of important economic institutions, contemporary economic circumstances have convinced

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[6] In mid-March 1986, government announced an export promotion scheme allowing issuance of certificates granting preferential tax incentives, credit and access to foreign exchange. . . . "Implicit in the package is the assumption that credit-starved manufacturers may turn their sights toward foreign markets, if only to obtain access to the credit and other privileges." George W. Grayson: "Mexico: The Oil Glut and Structural Reform," *Washington Quarterly*, Summer, 1986.

[7] *Financial Times*, April 18, 1988.

[8] State Department Cable, April 5, 1988.

[9] Enrique Krause, Mexican Historian, quoted in *The New York Times*, June 17, 1988.

the government of the need for additional direct foreign investment. Privatization of state enterprises requires private capital willing and able to purchase them. Expansion of exports requires firms with international sales linkages and state-of-the-art production capabilities. Finally, the lack of foreign bank lending means that greater reliance must be placed on direct investment as a source of new external funds.

In theory, foreign investment is restricted by a 1973 law which requires foreign firms to accept 49 percent minority ownership for their Mexican subsidiaries. In practice, however, the government has arranged numerous exceptions which permit international firms to have majority or exclusive ownership of Mexican subsidiaries. Further liberalization in the treatment of foreign investment is expected to take place in the future.

At present, foreign investment is actively encouraged by the "maquiladora" program, which permits 100 percent foreign ownership of plants which import parts for assembly into finished goods destined for export. Started in the mid-1960's, the maquiladora program has grown strongly even during the depressed period of the 1980's, boosted in large part by the several devaluations of the peso which made their exports more attractive in world markets. The number of maquila factories grew by an annual average of 16.6 percent between 1982 and 1986, creating 100,000 new jobs (a large fraction of the total created in the entire country during this period) and generating an increase of some $500 million in net export sales.

Despite its apparent success, few Mexicans regard the maquila program as an answer to the country's need for capital formation. Eighty-nine percent of all maquila factories are located near the border with the United States, providing an important source of regional tension inside Mexico. Maquila plants also have few links with the rest of the Mexican economy, purchasing a scant 2 percent of their total inputs from Mexican suppliers.[10]

For this reason, the Mexican government has been steadily moving toward a greater liberalization in the interpretation of the country's foreign investment laws. In May of 1986, the government launched an innovative program to swap the country's bank debt for new direct equity investments in Mexican businesses. This program, in effect, gives foreign direct investors a preferential exchange rate on new investments in Mexico, and puts them at a competitive advantage with respect to established domestic businesses. Buoyed by this swap program, approvals for new direct investment soared from $1.7 billion in 1985 to $2.31 billion in 1986 and $3.8 billion in 1987.[11] The costs to government of the swap program forced its suspension in 1987, and it is not clear how much of the "approved" new investment will in fact take place, but the change in attitude toward foreign investment nonetheless remains significant.

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[10] Mauricio de Maria y Campos, Undersecretary for Industrial Development, "Today's Dilemma in U.S.-Mexican Economic Relations," Paper prepared for U.S.-Mexico Binational Commission, April 1987, pp. 15–17.

[11] U.S. Embassy in Mexico, *Foreign Investment Climate Report*, March 1988, p. 31.

Candidate Salinas provided further evidence of this change in attitude when he told a reporter:

> We are a mature country, able intellectually, legally and economically to absorb larger flows of foreign investment without affecting sovereignty or freedom of action.[12]

The Broader Implications of Mexico's Stabilization Efforts

Economic policy both reflects and influences changes which have taken place in the institutions of government in Mexico. As the country has become more developed, power in the government and the PRI has slowly but distinctly shifted toward leaders with particular strengths in the areas of technology and administration. As a recent article noted:

> There is no doubt that the top decision makers in Mexico are increasingly individuals who have followed careers in academia and public administration and who lack experience with mass political organizations, such as the party or labor unions.[13]

Those who now control both the party and the government base their positions on an ability to produce an economy and a government which runs smoothly and efficiently. Economic deterioration both damages the credibility of these elites and undermines their limited base of popular support.[14] At the same time, fiscal austerity and a turn toward competitive markets limits the ability of local PRI officials to bring tangible benefits to their constituents.[15]

This problem was summed up concisely two years ago in an article by Mexican political scientist Jorge Castaneda, who observed:

> Mexico's overriding political problem stems from a simple and unalterable fact: the system, which has been traditionally clumsy in its handling of the middle classes, can no longer deliver the economic growth and prosperity that these classes now expect as a matter of course. At the same time, the political system does not feel it can grant them the additional measure of democracy which might be an acceptable alternative.[16]

Over the past two years, however, this "additional measure of democracy" has come to be seen by the Mexican elite as not only an acceptable but an inevitable alternative. Unwilling to abandon painful economic adjustment policies, the government has decided instead to respond positively to long-standing demands for greater democratization of the political process.

The 1988 elections marked a significant move toward political liberalization, and while there continues to be widespread skepti-

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[12] Carlos Salinas de Gortari quote in *The Reuter Business Report*, May 20, 1988.

[13] Roderick A. Camp, "The Political Technocrat in Mexico and the Survival of the Political System," *Latin American Research Review*, Vol. 20, No. 1, 1985, p. 104.

[14] This problem is often described in Mexico with the phrase: "The ruling class can no longer hear the grass grow." Riding, *op. cit.*, p. 115.

[15] "Economic crisis obviously saps the regime of resources. But so does the policy of economic opening. The fate of many businesses, unions and other groups will depend increasingly on efficiency and markets and less on official favors or the lack of them." Daniel C. Levy, "The Mexican Government's Loosening Grip," *Current History*, March 1987, p. 116.

[16] Jorge G. Castaneda, "Mexico at the Brink," *Foreign Affairs*, Winter 1985–1986.

cism about the results of the election, there is also widespread agreement that they marked the introduction of a new element of pluralism into Mexican political life. Whether this new political pluralism will sustain or obstruct the process of economic reform in Mexico is perhaps the most critical question to be answered during the first months of the next President's term.

VI. EVALUATING THE CHANCE OF SUCCESS

The Pacto has been welcomed as a potentially viable solution to Mexico's economic troubles by business and economic elites both inside [1] and outside Mexico.[2] Of particular importance are the attitudes of domestic elites associated with the previous approaches to economic policy. With respect to fiscal policy, former Finance Minister Jesus Silva Herzog, architect of previous stabilization programs, noted "This is the first time in my life that I have seen a really strict fiscal policy." [3] And another former Finance Minister, David Ibarra, commented that, while the present program created strains in the economy, "there is no alternative paradigm which commands widespread support among Mexican economists." [4] Erosion of support for previous approaches to economic policy had in fact significantly pre-dated the recent crisis.[5]

This widespread recognition of Mexico's economic problems, and the lack of an alternative to the present course of painful adjustment, are among the strongest reasons for optimism for the success of the Pacto. But economists who have examined other attempts at curing large inflations in complex and diversified economies have struck a cautionary note in their analysis of the current Mexican scene. Harvard's Jeffrey Sachs noted:

> It is encouraging that the Mexican programme is conceptually sound, unlike some similar programmes elsewhere, but this is the easy part. As the programme progresses they are going to face increasingly difficult economic and political problems, so I would caution against excessive optimism.[6]

In much the same vein, MIT Professor Rudiger Dornbusch observed that:

> The bad news about stabilization is that the first step, stopping inflation, is the easy part. The greater difficulty is to move from there to sustainable growth.[7]

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[1] "We think it (the Pact) is the single most important decision made by the present administration. It implies a desire to rally all social forces around a task which is arduous and challenging, but which will benefit the nation as a whole." Banco Nacional de Mexico, "Review of the Economic Situation of Mexico," February 1988, p. 65.

[2] "The jury is still out, but there is increasing evidence that the collapse of the oil price in 1986 has at last forced Mexico's elite to make long-overdue structural changes in the economy." *The Economist*, September 5, 1987.

[3] Interview, May 2, 1988.

[4] Interview, April 28, 1988.

[5] "Whether for businessmen or progressive economic planners, the Mexican economy has been turned into a nightmare by 40 years of protectionism, inefficiency, massive subsidization of both consumer staples and industrial inputs, and technological backwardness. It is hamstrung by excessive red tape involving everything from foreign investment to import permits, and from export taxes to land tenure. There is wide agreement in Mexico today on the problems, and on the economic necessity of addressing them." Castaneda, *op. cit.*

[6] *Financial Times*, March 2, 1988.

[7] Dornbusch, *op. cit.*, p. 39.

The Need for Growth

It is precisely this need to move to sustainable growth which sets the principal challenge to the administration in the months and years ahead. Everyone in Mexico regards the Pacto as a simple means for achieving the goal of stable, noninflationary growth, not an end in itself.

Mexico has a particularly acute need to return to a pattern of rapid GDP growth. Not only does the country have a long history of impressive economic growth which has become part of the experience and expectations of its citizens, it also has a demographic profile which makes rapid growth a requirement for social stability.

Figures 12 and 13 compare the population pyramids of Mexico and the United States. The extraordinarily "bottom heavy" demographic profile of Mexico, a legacy of rapid population growth during the 1960's and 1970's, means that the population as a whole is very young, and that the working-age population is growing much more rapidly than the rest of the population as young people move into the work force. This demographic profile means that Mexico must find work for some 800,000 to 1 million new workers each year to avoid having unemployment rise. This creates a need for real growth in GDP in the range of 4 to 6 percent per year simply to stabilize the unemployment rate.[8]

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[8] Buffie and Krause, *op. cit.*, p. 168.

Figure 12

MEXICAN POPULATION PYRAMID

by age and sex, 2020

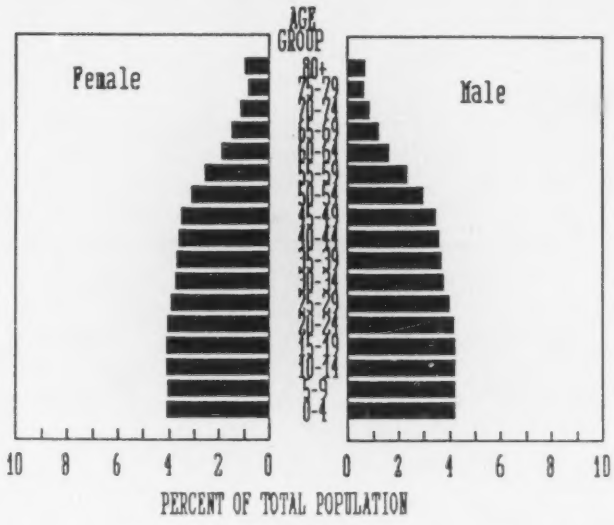
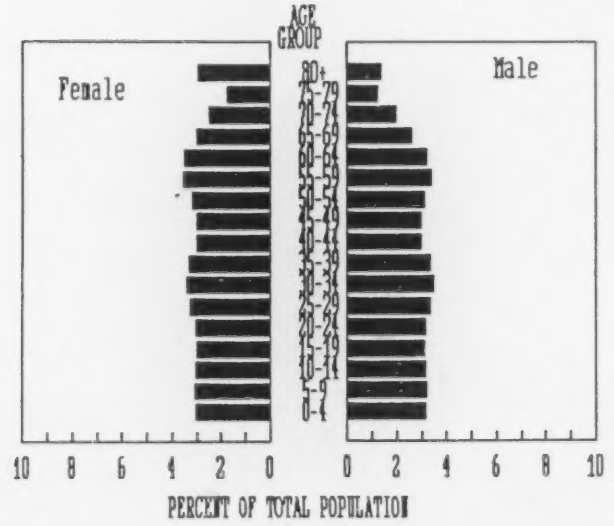


Figure 13

U.S. POPULATION PYRAMID

by age and sex, 2020



Growth in roughly this same range is also needed to sustain the commitment both inside and outside the government to carry forward the present difficult reforms. As the Undersecretary of Commerce for Industrial Development put it:

> Permanency of the process of change that has been initiated which includes trade liberalization and industrial reconversion policies may be threatened, if an adequate rate of growth of the market and of the needed resources for investment is not secured.[9]

Rapid growth also offers an indirect means of addressing the tensions arising out of the extreme inequality of income distribution in Mexico. As one authority put it: "Without a growing economy, the tensions that result from the extremely skewed distribution of wealth will persist and probably increase." [10]

Finally, a resumption of growth is needed to halt the dangerous drift of qualified Mexican's out of the country. As the *Financial Times* noted recently: "The 1986 Simpson-Rodino Act has not really cut back emigration, rather it has made illegal entry more expensive. This tends to encourage an exodus of the people Mexico can least afford—qualified personnel." [11]

Threats to Growth

Despite these manifest needs to get growth going again, the ability of current policies to promote a resumption of growth is highly uncertain. Producing sustainable, noninflationary growth at rates sufficient to deal with Mexico's political and economic problems will require a delicate task of policy navigation, to steer the economy between the twin dangers of renewed inflation on the one hand, and prolonged stagnation on the other.

Renewed Inflation

There is substantial pessimism in Mexico that the fight against inflation will not succeed. Prices will stabilize for a while, but soon price controls will become ineffective, and the economy will enter yet another spiral of inflation. There are three bases for an argument that renewed inflation is possible in the Mexican case: history, politics and the exchange rate.

History.—There is, unfortunately, ample precedent for such a conclusion. As Figure 14 demonstrates, most large countries which have experienced big inflations have been unable to achieve permanent success in their efforts thus far at price stability.

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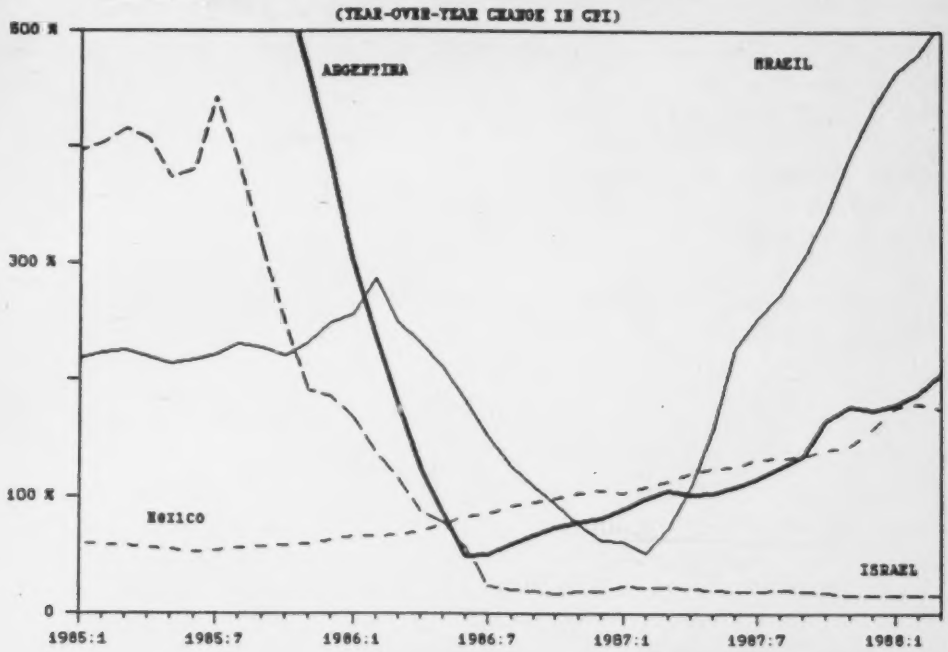
[9] Mauricio de Maria y Campos, *op. cit.* p. 10.
[10] Purcell, *op. cit.*, p. 59.
[11] *Financial Times*, December 10, 1987.

Figure 14

STABLILIZATION POLICIES



In Latin America, both Brazil and Argentina launched ambitious "shock" plans with many of the same elements contained in the Mexican plan. Both plans came apart rather quickly when the country started growing again. Israel and Bolivia seem to have had better success with combining renewed growth and low inflation, but these two countries are very different from Mexico. Even apart from differences in policy, size alone may make the task of economic management easier in smaller countries.[12]

On a more positive note, recent analyses of both the Argentine and Brazilian stabilization efforts have concluded that the resumption of inflation was due in large part to high fiscal deficits at the start of the program, and a relaxation of fiscal discipline early in the stabilization effort. Mexico has a substantially tighter fiscal policy than did these other countries at the start of their programs, a factor which might make Mexico an exception to the rule of renewed inflation in the large economy context.

Political Opposition.—The economic policies adopted by both de la Madrid and Salinas do not command universal support in Mexico. Many inside the party and the government are anxious

[12] "It seems easier to implement such a programme in a small, centralized economy like Israel's than in a large, diversified one like Brazil's or Argentina's." *The Economist*, July 16, 1988, p. 63.

over the pace at which economic liberalization and privatization is proceeding, partly out of conviction that there was merit to the old strategy, and partly out of concern for their jobs as the Mexican state bureaucracy sheds functions and staff.[13]

Outside the PRI, the opposition parties have been denouncing the domestic austerity and the "dismantling" of the public sector which is a central part of the current strategy for economic stabilization. In the 1988 presidential elections, those groups most opposed to the current strategy united behind the candidacy of Cuauhtemoc Cardenas, whose National Democratic Front captured a large majority of the opposition vote.

According to Professor Lowenthal, the approach favored by many opposition elements:

> . . . would strengthen the state sector; stress redistributive policies and social programs; orient more production inward, toward the expansion of local markets; and assign priority to generating full employment . . . [it] emphasizes the aim of accelerated recovery from Mexico's depression. It would limit current debt service to levels that will permit Mexico to resume growth.[14]

The strong opposition showing in the July elections, along with the support for these ideas inside the PRI apparatus itself, increases the probability that the government will have to accept compromises on some of its economic policies far sooner than they would have wished. As former Finance Minister Silva Herzog noted even before the election, "The next government will be forced for political and economic reasons to stimulate the economy." [15]

The Exchange Rate.—A key element of the Pacto is a freezing of the exchange rate. Fixing the exchange rate between the peso and the dollar is seen as important symbolic evidence of the government's commitment to price stability.

But as Figure 15 shows, Mexico has regularly run into problems defending a fixed exchange rate when there were substantial differences between United States and Mexican inflation.

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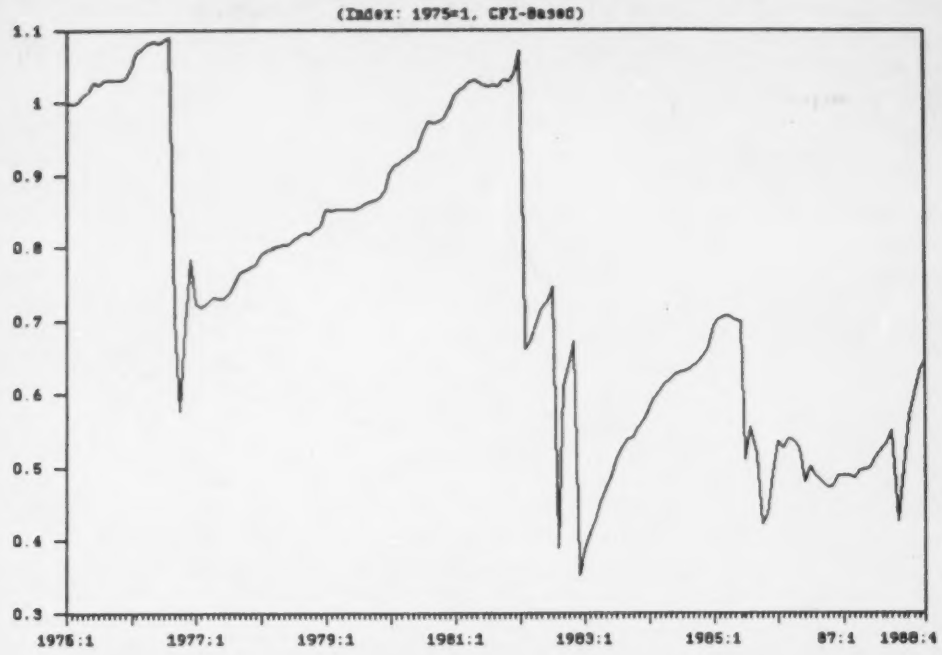
[13] Luis Rubio, "No Room for Compromising With Cardenas' Big-Government Policies," *Los Angeles Times*, July 12, 1988.

[14] Lowenthal, *op. cit.*

[15] Interview, May 2, 1988.

Figure 15

THE REAL PESO-DOLLAR EXCHANGE RATE



The clear pattern in Mexico is to cling to a fixed exchange rate despite faster domestic inflation, resulting in a steady upward crawl in the real exchange rate. At some point, this increasingly overvalued exchange rate causes Mexican wealthholders to anticipate a devaluation and move capital out of pesos and into dollars (or other hard currency). The resulting run on the peso eventually causes a devaluation, only to start the process all over again.

As the chart suggests, this process seems to be repeating itself in 1988. Following the devaluation of 1987, the peso was undervalued, providing a major spur to Mexican non-oil exports, but also putting upward pressure on import prices. The decision to fix the exchange rate despite an inflation rate much higher than in the United States is pushing the real exchange rate upward, squeezing profit margins on Mexican exporters but providing a useful measure of downward pressure on the overall price level.

At present, exchange rate policy is primarily directed toward the fight against inflation, but there is substantial concern that this cannot persist much longer. Mexican businessmen (who are also the major owners of Mexican liquid wealth) are constantly and vocally complaining about the rising real value of the peso hurting both their profit margins and their ability to compete in international markets. At some point, the appreciating exchange rate could become "overvalued" in the eyes of Mexican investors, leading to renewed capital flight and further market pressure on the government to devalue.

Such a development could mark the end of the Pacto. All participants in the economic debate understand that it is a price like any other, and once a decision has been made to let exporters effectively increase their prices (through devaluation), there will be pressure from other sectors for similar treatment. Because businessmen often price their goods by reference to the exchange rate, inflationary expectations in Mexico tend to be tied to this variable.[16]

Given the pact's initial emphasis on allowing periodic price adjustments, it would be very difficult for the government to resist such demands, having given in to the exporters. It is possible the government could adjust prices, then freeze again (as originally envisioned in the pact), but it is also possible that once the inflation catch-up process started, price stability would be much harder to maintain.

At present, the government is hoping that inflation will come down fast enough to relieve pressure on the exchange rate without the necessity for a devaluation. So far, Mexican wealthholders appear willing to give the government some essential breathing room on this issue. Although official statistics showed central bank reserves falling by some $4.5 billion between May 1, 1988, and July 31, 1988, there is as yet no sense of a wholesale flight of capital which usually precedes a devaluation crisis. But given Mexico's history, and the increasingly strident statements from the business community about the need for further currency depreciation, it may be only a matter of time before such pressures mount to an irresistible level.

Deepening Stagnation

The second scenario of for the failure of the Pacto is the obverse of the inflation scenario—price stability but no economic growth. Most of the measures used to stabilize prices involve depressing domestic demand, and the broader the package of recessionary tools, the deeper the recession. It is possible that present policies have already sent the domestic economy down a path leading to a prolonged period of stagnation.

A number of pieces of evidence and argument point in this direction. The Minister of Planning, Pedro Aspe, initially announced that growth for 1988 should be between 0 and −4 percent.[17] Growth through the first half of 1988 was substantially above expectations, but if the economy weakens toward the end of the year, it may be quite a task to turn the economy around.

MIT Professor Rudiger Dornbusch, in a generally supportive review of current Mexican economic policy noted:

> Too much austerity, beyond the current surplus, would risk a deep slump in economic activity which carries its own risks. If stability is not followed by a resumption of growth then the sustainability of the budget cuts soon comes into question. Thus excessive zeal on the budget carries its own serious risks.[18]

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[16] U.S. Embassy, *Economic Trends Report*, April 1988, p. 10.
[17] *Financial Times*, April 14, 1988.
[18] Dornbusch, *op. cit.*, p. 35.

If *further* austerity risks "a deep slump" it is at least possible that *present* austerity is already sufficient to produce such a slump. It remains an open question whether existing measures to depress demand have not already pushed the country into a self-reinforcing downward spiral.

This worry has recently been articulated by economists at the Banco Nacional de Mexico:

> One of the most serious consequences of the economic situation of the last few years has been the reduction of the income of large sectors of the population. Increasing our presence in foreign markets should not mean neglecting domestic ones. Both the capacity to buy, as well as the capacity to save, must be reestablished. . . . It is difficult to achieve more participation, via jobs and salaries, without an increase in investment, since this determines work demand. Nevertheless, it may not take place at all if there are no favorable possibilities for a permanent domestic market. This requires improving the purchasing power of the people.[19]

The Search for a Growth Engine

"Improving the purchasing power of the people" means that some part of the Mexican economy will need to start growing rapidly to generate the incomes which could serve as a stimulus to revive domestic demand. But a review of the major components of the Mexican economy provides little clear evidence that such a "growth engine" is likely to materialize over the intermediate term.

As in any economy, the basic sources of demand growth are private consumption, private investment, public consumption and investment, and exports. The decision of the government to control wages as a key element of its inflation-fighting program effectively rules out any significant expansion of private consumption in the near future, so Mexico's search for a growth engine has to focus on some combination of private investment, public spending or exports.

Exports.—At the moment, the outlook for exports is extremely uncertain. Overall, the value of Mexico's exports is extraordinarily dependent on the international price of oil, with roughly 40 percent of the country's export earnings coming from this single commodity. International oil markets have been weak for the past several months, and the outlook for the future remains uncertain. For the first five months of 1988, the value of oil exports was 16.6 percent below the level recorded during the same months of 1987. If international oil prices remain weak, the petroleum sector and its affiliated domestic suppliers will provide little overall stimulus to the economy.

Prospects are somewhat better for the non-oil export sector. With the 1987 devaluation of the peso, Mexican firms received a strong incentive to export. In response to this incentive, Mexican non-oil

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[19] Banco Nacional de Mexico, *Review of the Economic Situation of Mexico*, December 1987, p. 409.

exports surged by 41 percent in 1986 and 23.7 percent in 1987, bringing their total to some 8.7 percent of GDP in 1987. While not as substantial as investment (15 percent of GDP) or government spending (44 percent of GDP), the rapid rate of growth of the non-oil export sector makes it a potential candidate as a growth engine.

At the moment there are factors which are likely to inhibit the ability of the export sector to pull the rest of the economy forward. At present, the non-oil export sector in Mexico has a very narrow geographical and structural base. It is concentrated largely in two sectors—automobiles and electronics assembly—and is also concentrated in the north of Mexico, where access to the U.S. market is relatively convenient. For exports to become a strong economy-wide growth engine, substantially greater geographical and sectoral diversity will be needed.

Broadening the base of exports requires two things: companies producing largely for the domestic market need to redirect their activities to exports, and exporting firms need to expand capacity and undertake substantial new investments. While both developments appear to be underway, their pace is inhibited by a number of factors.

First, exporters are concerned that present exchange rate policies are steadily eroding their international competitiveness. This real exchange rate appreciation is partly responsible for the recent deterioration in Mexico's trade balance. For the first five months of 1988, the trade surplus was 45.6 percent lower than it was for the same period in 1987, as exports suffered from the appreciating peso, while imports surged. It is unlikely that export demand will spill over into increased construction of new export capacity until it is clear that either inflation has been tamed or the exchange rate allowed to adjust.

Second, Mexico has not succeeded in diversifying its export markets away from the United States, which still accounts for 77 percent of the country's non-oil exports. Concerns about what will happen to the United States market in the face of America's current large international trade deficits also acts to depress Mexican investment on capacity designed to sell into the American market. Any strategy for export-led growth would have to offer some prospect of continued growth in the United States market for Mexican goods.

Third, the expansion of export capacity is inhibited by the lack of adequate transportation and communications infrastructure. Most bulk exports need to be carried over the railroad system, which operates at average speeds less than one-third those in the United States, due to deteriorating track bed and rolling stock. Road transportation is inhibited by the collapse in highway construction and maintenance.

Investment.—Since 1982, private investment in Mexico has stagnated, but there is hope that the Pacto will affect a reversal of this trend. The magnitude of the investment problem was outlined in a recent speech by businessman Claudio Gonzalez:

> Private investment has diminished for a number of reasons, amongst which we can mention the following: (A) the macroeconomic instability that arises from an accelerating

> inflation; (B) insufficient internal savings, which have been the result of the lack of a permanent policy of positive interest rates; (C) the lack of confidence or insecurity, that explain the large proportion of domestic savings held abroad; (D) the sizable public sector financial requirements that have absorbed a great proportion of national savings; (E) the lack of a fiscal regime that effectively stimulates investment; (F) the unfair competition from government enterprises, in terms of privileges, advantages and exceptions to the law; (G) the excessive red tape and over regulation of economic activity; and, finally, (H) the lag in infrastructure construction.[20]

Several elements of the Pacto have been designed to reverse some of these negative factors, but the short-run climate for renewed business investment nonetheless remains highly uncertain. In early 1988, most of Mexican industry was operating at less than 60 percent of capacity after the prolonged austerity of the 1980's.[21] There remains, therefore, a substantial reservoir of existing capacity which will need to be brought back into production before any major surge in investment spending should be anticipated.

Trade liberalization and exchange rate depreciation provide a stimulus to export firms, but puts strong price pressure on domestic producers and cuts into profit margins, the traditional source of finance for new investment in Mexican business.[22] President Salinas made reference to this recently in a speech which noted:

> We realize we are asking industries that have been seriously hurt by market reductions and limited resources to compete internationally on an equal basis at a time when there is also a possibility of a world recession, in which case international industries would try to sell their surplus products to Mexico. Undoubtedly, the business mortality rate in the next few years will break all previous records unless we change the current patterns and start implementing innovative solutions.[23]

The prospect of record "business mortality" is hardly an environment conducive to a major expansion of private investment.

Currently monetary conditions also are not favorable to a surge in investment for those firms needing external finance for new investment. Short-term interest rates remain very high, pushing all capital market activity toward the short-term end of the maturity spectrum. Some businesses might be willing to finance long-term investment projects with short-term borrowing in anticipation of a rapid decline in short-term rates, but such behavior cannot be expected of the large majority of Mexican businesses.

A third important element in slowing the pace of new private investment is the sharp deterioration in public infrastructure mentioned above. According to a recent study:

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[20] Claudio X. Gonzalez, speech delivered to American Center for International Leadership Conference, April 25, 1988.

[21] Mauricio de Maria y Campos, Undersecretary of Commerce, interview, May 2, 1988.

[22] "Industry's splitting into two halves," says one observer. "One-half is jumping into exports, and the other is going broke." *Business Week*, September 14, 1987.

[23] Interview with XHTV Television, April 15, 1988.

> Investment expenditures for infrastructure capital have also been severely slashed. As many types of infrastructure capital enhance the productivity of private sector capital, the latter cutbacks have, like import compression and the reduction in bank lending, lowered the profitability of private investment.[24]

The recent presidential elections also cloud the prospects for business investment. The small margin of victory for Salinas, and subsequent protests by the opposition, increase uncertainty about the future course of policy. While there have as yet been no signs of a rapid exodus of capital from Mexico or a collapse in business confidence, current conditions are likely to produce a prolonged period of "wait and see" with respect to business investment.

Public Spending.—Traditionally, it has been the public sector which has served as the growth engine to pull the economy out of a slump. The usual mechanism has been an expansion of the public sector deficit, through increased subsidies, increased spending by para-statal enterprises, and increased public-works investment by the federal government. Surges in the federal deficit have traditionally coincided with election years, and there was a good deal of pressure within the PRI during 1987 for a similar expansion in 1988.

But fiscal restraint by government is a key element of the Pacto, and the government seems determined to move ahead with cuts in subsidies and shrinkage of the para-statal sector. The fact that the budget deficit continued to contract throughout the 1988 campaign is evidence of a strong commitment to fiscal discipline.

This commitment to fiscal discipline does not indicate, however, that government officials see no need for increased economic activity by government. On the contrary, there is much talk of the need to rebuild the nation's transportation and communications infrastructure which has deteriorated markedly during the 1980's. Figure 16 shows the precipitous decline in public investment during the decade, much of which was taken out of spending on transportation infrastructure.

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[24] Buffie and Krause, *op. cit.*, p. 161.

Figure 16

This decline in infrastructure is visible throughout Mexico, and is starting to have a damaging impact on economic growth and efficiency. The costs of transporting goods by road has risen dramatically, as deterioration of existing roads and a reduction in new construction adds significantly to the deterioration of truck transport. And the shocking deterioration of telephone service in Mexico is proving especially difficult for firms needing to develop international export markets.

In view of the significance of the infrastructure problem, the government has indicated a desire to reverse the downward trend in public investment spending. But because of budgetary realities, there is no inclination to expand the deficit along with any expansion of infrastructure finance. Resources for infrastructure investment in the public budget will have to come either from increased revenues or from decreased expenditures. This fiscal constraint sets serious limits on the ability of government to expand infrastructure investment.

From this brief review, it is clear that Mexico's policymakers face acute difficulties in getting their economy back into a path of stable, noninflationary growth. If inflation-fighting is pushed to extremes, it risks the collapse of both domestic demand and domestic investment. If growth is pursued without regard to inflation, there is grave danger that the economy will simply repeat the cycle of renewed inflation and further economic destabilization.

VII. U.S. INTERESTS AND MEXICAN ECONOMIC POLICY

Mexico is in the midst of an extraordinary transformation of both economic policy and the political system. The government has embarked on an ambitious but painful program designed to restructure the Mexican economy, and at the same time is experimenting with an opening of the political system. Political opening increases the pressures to show "results" of the program in the form of increased incomes and GDP growth.

From the U.S. perspective, it is vitally important that Mexico succeed with its reforms. Our interests are best served by a prosperous and efficient Mexico, and the dismal alternatives of renewed inflation or deepening stagnation both pose serious threats to important U.S. interests. As one observer of hemispheric affairs recently noted:

> Unless Mexico can regain the momentum of economic dynamism, spread its benefits more widely and equitably, and renew widespread public confidence, pressures on Mexico's long-term stability will continue to increase. Mexico is by no means a tranquil neighbor. It is deeply troubled, and its troubles are increasingly affecting the United States.[1]

One major channel through which Mexico's problems affect the United States is immigration. Given the length of the border, and the cultural and economic integration of communities across the border, there is very little likelihood that the border could be turned into an inpenetrable wall to keep Mexico's troubles bottled up in Mexico itself.[2] It seems clear that our proximity means that the United States, in one way or another, will be affected by the consequences of both success and failure in Mexico.

It is equally clear, however, that Mexico's future course will be determined largely by decisions taken inside Mexico. The United States, as Mexico's largest trading partner and neighbor, can help establish an environment in which the right policies can succeed, but the policies themselves must be formulated in Mexico.

Given the current economic realities inside Mexico, renewed growth needs to be led by investment and exports, not consumer demand, which will need to follow the expansion of capacity if runaway inflation is to be avoided. The United States can help create an environment for such a trade-and-investment led expansion in two ways: dealing with the external debt problem, and creating opportunities for expanded trade between the two countries.

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[1] Lowenthal, p. 74.

[2] "Immigration Law Is Failing To Cut Flow From Mexico," *New York Times*, June 24, 1988.

THE DEBT

Mexico's roughly $103 billion of external debt creates a set of economic pressures on the country, pressures which vastly complicate the search for stable, noninflationary growth. A recent paper from the Council on Foreign Relations describes in some detail the problems created by a large external debt burden in the context of macroeconomic stabilization efforts:

> Finally, the debt overhang is complicating the task of policy reform by contributing to macroeconomic policy instability. For example, interest payments on foreign debts are a major source of large budget deficits. As fiscal austerity is pursued by cutting non-interest government expenditures, the economy slumps causing revenues to shrink and frustrating the goal of deficit reduction. With increasing success in paring the non-interest expenditures, the share of interest payments in the overall budget goes up, leaving progressively less room for achieving future success in deficit reduction. As the ballooning interest bill on foreign debts remains untouchable, the battle to reduce the budget deficit never ends, with fiscal policy continuing to drag the economy downward.
>
> Policy adjustments in the external sector to service the debt overhang further destabilize the macroeconomy. Currency devaluations to generate trade surpluses put upward pressures on inflation and nominal interest rates, and raise the government's local currency interest bill on foreign debts. The budget deficit widens once again leading to inflationary monetization, ultimately calling for monetary and fiscal austerity. Monetary tightening and real interest rate hikes to fight inflation and capital flight further depress the economy. The vicious cycle of recession-inflation-deficit-depreciation undermines business confidence and encourages capital flight, putting additional negative pressure on growth and the balance of payments.[3]

For these reasons, it is becoming clear to many observers that excessive debt-servicing obligations pose a threat to countries which are trying to combine renewed economic growth, structural change, and price stability.

At a theoretical level, the basic problem is not debt *per se* but the effect which this debt has on the availability of real resources to finance a sustainable, noninflationary expansion of output. Excessive debt burdens not only block a country's access to international capital resources, but also force the country to transfer large amounts of scarce domestic savings out of the country in the form of debt service.

For countries like Mexico, stable growth requires a rapid expansion of capital investment, in order to provide the rapidly growing working-age population with productive employment. Such a rapid expansion of investment is particularly important for countries at-

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[3] Shafiqul Islam, "Breaking the International Debt Deadlock," Council on Foreign Relations, February 1988, p. 8.

tempting structural reform, since the new opportunities created by privatization and trade liberalization must be developed with extensive new investment. Expanded investment in turn requires an expansion of the savings needed to finance the investment.

Historically, countries in the process of modernization or profound structural change have been able to augment domestic savings by importing financial resources from abroad. Around the turn of the century, the United States and Canada both borrowed heavily to finance their drive to industrialization, a process repeated by Australia somewhat later in the century.

Unfortunately, Mexico tapped international sources of savings during the late 1970's, at a time when oil was providing an adequate growth engine for the economy, the expansion of the labor force was proceeding at only a moderate rate, and government policy was uninterested in basic structural reform of the economy. As a result, little of the foreign borrowing went into capacity-expanding investment, and a great deal was diverted into wasteful consumption or capital flight.

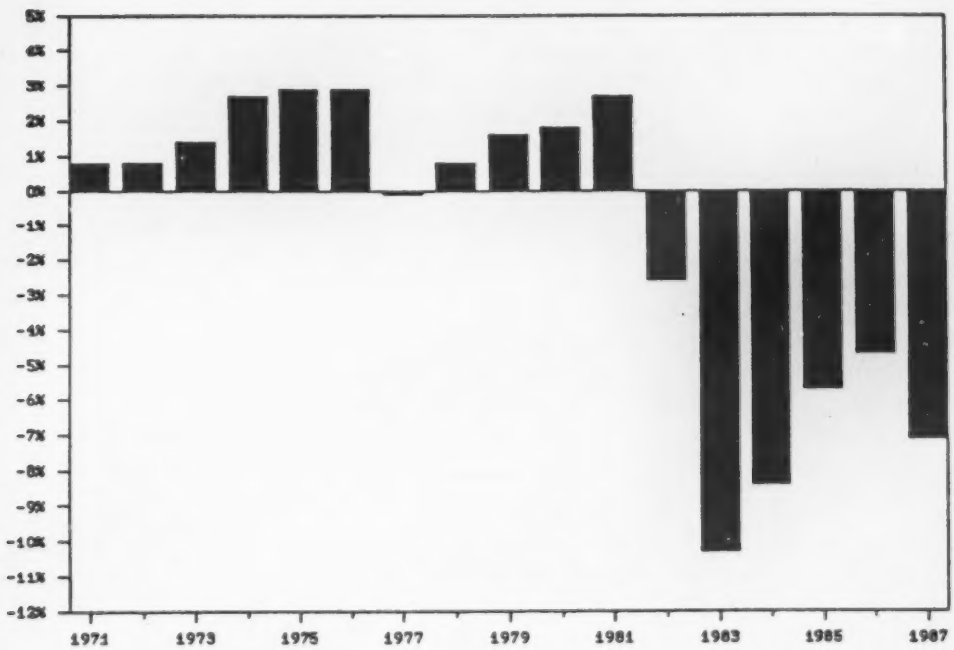
Now, when the country is in great need of new investment and the government is committed to economic reform, Mexico's ability to call on external savings has all but vanished. In fact, Mexico since 1982 has been transferring its own scarce domestic savings abroad in the form of debt service, rather than supplementing domestic savings with inflows of foreign capital.

The most convenient and available measure of how much savings are being transferred to or from a country is the "non-interest current account" [NICA], a measure which subtracts interest payments (the principal source of financial outflow) from the country's overall current account. Countries with a NICA deficit are receiving net inward transfers of savings, while countries with a NICA surplus are exporting savings to the rest of the world.

Figure 17 shows the NICA calculations for Mexico during the past decade. It indicates that Mexico received positive resource transfers of roughly 1.5 percent of GDP during the late 1970's, but swung dramatically toward negative (outward) transfers of savings during the 1980's. These outward transfers reached a peak of nearly 11 percent of GDP during 1983. During 1986, when substantial new loans eased the Mexican finance situation, the country was exporting savings at a rate of 4.7 percent of GDP, and the figure rose again to 7 percent in 1987.

Figure 17

RESOURCE TRANSFERS AS SHARE OF GDP



Source: Dornbusch

Outward resource transfers of such magnitude make it virtually impossible for Mexico to experience both economic growth and price stability. The real resources needed for a noninflationary expansion of productive capacity simply are not available, and this lack of resources leaves the country with two equally unpalatable alternatives—slow growth or renewed inflation. In this context it is important to note that Israel, one of the few countries to achieve successful disinflation while maintaining positive growth, did so with the help of substantial financial assistance from the United States.[4]

While economists provide different estimates of how much improvement in the external resource transfer equation is needed to produce a given rate of sustainable, noninflationary growth, there is general agreement on the proposition that the lower the outward resource transfer, the faster the economy can grow without excessive inflation. Econometric estimating techniques based on growth in the 3 to 4 percent range yield estimates of net resource flows which vary from the optimistic calculation that the country could manage adequate growth with an *outflow* of $4.2 billion (3 percent

[4] *Financial Times*, February 29, 1988.

of GDP),[5] to pessimistic ones which require net new *inflows* of some $7 billion per year.[6] Both represent a substantial swing from the $8.1 billion outflow experienced during 1987.

Improvement in the external resource transfer equation can come about in one of two basic ways: inflows could be increased, or outflows reduced.

Prospects for New Inflow

In order to alter the resource transfer equation, it is necessary that inflows increase *from the current levels,* since the existing resource transfer balance reflects existing levels of inflows. In fact, an improvement in the resource transfer balance is likely to require a substantial increase, since recent rises in interest rates worsen the outward transfers associated with interest payments, and Mexico is scheduled to begin repaying principal on some of its old debt within the next few years.

New inflows can come from four basic sources: private commercial banks, private foreign interests, public entities and a repatriation of flight capital held overseas by Mexican nationals. For most of these sources, 1987 was an unusually favorable year, and it is doubtful if 1987 inflows could even be maintained in coming years, much less increased.

According to IMF statistics, $3.2 billion of new direct investment flowed into Mexico during 1987, more than double the figure for the previous year. Much of this, however, was associated with the country's "debt for equity swap" program, which provided incentives for new equity investment. The program has been halted by Mexico because of its inflationary implications, and prospects for renewal are uncertain. In any case, new "investment" produced by a swap program should properly be counted as part of a strategy for reducing outflows (through debt reduction) rather than finding truly new inflows.

While it is difficult to gather precise statistics on movements of flight capital, one convenient shorthand measure is to examine the "errors and omissions" component of the current account. After several years where errors were sharply negative (implying capital fight), this component turned positive in 1986 and grew in the positive direction in 1987, suggesting a return of flight capital. Much of this return, however, was associated with the past devaluations and very high real interest rates in Mexico, and is likely to be in much shorter supply during the coming period of uncertainty about the exchange rate.

The World Bank and the IMF also increased their lending to Mexico during 1987, producing net increases in their exposure to

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[5] Dornbusch, who developed this estimate as a theoretical possibility, has little confidence in the optimistic assumptions upon which it is based.

[6] Selowsky and Van der Tak of the World Bank note: "Any program of adjustment compatible with a sustained 'minimum' GDP growth in the range of 4 percent a year will require significant net borrowing as a percentage of GDP, particularly in the short run. During the first three years of such a program, these annual flows may be around 3 to 5 percent of GDP for countries with a medium debt overhang, and approximately 5 to 9 percent for countries where such overhang is near 10 percent of GDP." Mexico, with a debt "overhang" of 6 percent of GDP, would thus appear to need inflows in the range of $7 billion. See Marcelo Selowsky and Herman G. van der Tak, "The Debt Problem and Growth," World Bank, Operations Policy Staff Memo, January 21, 1986, p. 20.

Mexico of some $1.3 billion, up sharply from the $979 million net inflow during 1986. Given this sharp increase, and the other claims on multilateral bank resources, it is not reasonable to expect continued growth on this scale in the future.

This leaves the private banking system as the principal source of new resource transfers to Mexico. During 1985 and 1986, commercial banks reduced their exposure to Mexico, extending less in new loans than they received in principal repayments. In 1987, however, this pattern was reversed, with commercial banks actually increasing their exposure to Mexico by $3.8 billion as a result of the 1986 Mexico loan agreement.[7]

Few analysts predict that this pattern of increasing bank exposure to Mexico will continue. Although Mexico has been one of the most cooperative of debtor countries, the international banking community has moved sharply away from expanding loans to any heavily indebted country. Instead, banks have been building up their loan-loss reserves and cutting their exposure to borrowers such as Mexico, which suggests that banks are unlikely to step forward over the medium term to expand new lending.

In fact, a recent letter to the IMF and the World Bank from the Managing Director of the Institute for International Finance (a research group funded by major commercial banks) suggests that the commercial banks are pulling back from new commitments to most heavily-indebted countries. The letter noted: "The demand for bank financing from developing countries exceeds the capacity and willingness of the banks to supply it." [8]

From this review, it seems highly doubtful that new inflows of capital on the scale required to sustain adequate growth in Mexico will be forthcoming over the next several years.

The Prospects for Reducing Outflow

Given the considerable pessimism concerning the availability of sufficient new inward transfers to permit stable, noninflationary growth, the attention of both Mexican officials and international economists has turned toward the other mechanism for reducing the net outward resource transfer—cutting back on interest payments associated with the old debt. This objective can be accomplished either by reducing the principal or negotiating some change in the interest obligation.

To date, Mexico has concentrated largely on reducing the principal value of its outstanding debt, through pioneering programs of "financial engineering." In 1986 it launched an ambitious "debt-for-equity swap" program which permitted foreign investors to buy Mexican debt at a discount on international capital markets, then convert that debt into equity in Mexican firms at a higher value than the investors originally paid for the debt. This program was a strong incentive for foreign investment, but put the Mexican government in the position of replacing dollar-denominated foreign debt with peso-denominated domestic debt, since the government had to borrow the pesos to give the foreign investors in exchange

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[7] U.S. Embassy in Mexico, *Economic Trends Report*, March 1988, p. 21.

[8] Horst Schulmann, Managing Director, Institute for International Finance, letter to IMF and World Bank directors, quoted in *American Banker*, September 14, 1988, p. 2.

for their dollar-debt claims. The high costs of this program forced its suspension in 1987, but during its year of operation the program managed to reduce public sector external debt by roughly $1.4 billion.[9]

An even more ambitious program for debt reduction was put together last year by Morgan Bank. The plan involved swapping Mexican debt at a discount for new Mexican government bonds, the principal of which was guaranteed by a special issue of United States Treasury zero-coupon bonds. The bidding for these new bonds was well below expectations, yielding a reduction in debt of only $1.1 billion, largely because there was no guarantee of the interest payments on the new debt. Government and bank officials are now at work on a second "debt-for-bonds" swap which will deal with some of these problems.[10]

Despite the modest success of both the "debt-for-equity" and "debt-for-bonds" program, the huge debt service overhang remains a major problem for Mexico, and in the absence of a substantial increase in inflows of financial resources, this overhang will need to be addressed in a more comprehensive and ambitious fashion.

There are a number of possibilities which could be explored in pursuit of a long-term solution to Mexico's debt problem. Options include swapping a large fraction of Mexico's bank debt at a discount (the Morgan plan on a much enlarged scale, probably with extensive international financial backing); capping interest payments at some fraction of export earnings and adding the unpaid interest to the principal of the loan; and paying interest in local currency for reinvestment in the local economy.

The precise nature of any new debt-management scheme would need to be worked out between Mexican officials and international creditors, since it is important to avoid unilateral actions on this complex subject which might destabilize the international financial system or put the Mexican economy in jeopardy.

But while the details should be open for negotiation and creative compromise, the direction for United States policy ought to be clearly in favor of a resolution to the debt problem which permits renewed, noninflationary growth in Mexico. Such a posture is also consistent with the new consensus on the debt problem which is emerging in both the industrialized and the developing world.

The Emerging Consensus on Debt

Reducing the debt service burden on Mexico would free up budgetary resources which are urgently needed to support renewed public investment projects, as well as taking pressure off the exchange rate and permitting a re-establishment of business confidence in the export sector. These economic arguments are buttressed by a growing consensus both in Mexico and abroad that some form of debt reduction will eventually be needed by many heavily-indebted countries if they are to resume economic growth.

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[9] U.S. Embassy in Mexico, *Economic Trends Report*, April 1988, p. 19.
[10] *Wall Street Journal*, July 6, 1988.

Internationally, proposals for reducing the debt burden have been advanced by major private banking figures,[11] by the Japanese government,[12] by private research institutions,[13] by the United Nations Conference on Trade and Development,[14] and by a distinguished panel of bankers and financial experts called together by the United Nations Association of the United States.[15]

Inside Mexico, the consensus is even stronger on the need for reduction in the external debt burden. During the 1988 election campaign, Cuauhtemoc Cardenas made debt reduction a main plank in his platform, and achieved sufficient electoral support to become an important force with whom the administration must bargain in the new environment of political pluralism.

Many of his other platform ideas, such as a restoration of price subsidies and a re-nationalization of industry, are seen by the Salinas group as a step *backwards* in their efforts at economic reform. But they see a renegotiation of the debt as *compatible* with the long-run goals of economic reform, price stability and renewed growth.

For this reason, international debt was one of four issues which Salinas proposed as the basis for negotiation between the government and the opposition following his formal selection by the Congress as President-Elect. Salinas has also spoken out directly on the debt issue, stating:

> Mexico has to start growing again—a million young people demanding new jobs every year requires growth. This is the reason that we will service the debt only if we grow.[16]

Later, in a more detailed interview, Salinas defined the objectives of his administration on the debt issue as "write-offs of principal and cuts in interest payments." [17] Senior officials confirm the same view. Finance Minister Gustavo Petricioli announced a goal of cutting debt service from 7 percent of GDP to around 3 percent,[18] while Pedro Aspe, Salinas' successor as Minister of Planning declared: "The moment has arrived to design mechanisms which reduce the nominal value of the debt to its market value, so that it is the debtors who capture the total amount of the discount."[19]

Sentiment in favor of a tough renegotiation of the debt appears also to be building inside Mexico's business community. Eduardo Legorreta, Chairman of a major brokerage house and a key spokes-

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[11] James Robinson, CEO of American Express, launched a proposal for reducing the debt burden early in 1988. Later in the year, Robinson indicated that his proposal was endorsed by Richard Flamson of Security Pacific Bank, C.E.D. Ritchie of the Bank of Nova Scotia, and Alfred Herrhausen of Deutsche Bank. *American Banker,* August 17, 1988.

[12] A Japanese debt proposal was presented to the Toronto Economic Summit, but received little serious attention. *The Economist,* August 6, 1988, p. 62.

[13] John Williamson, "Voluntary Approaches to Debt Relief," Institute for International Economics, September 1988.

[14] UNCTAD issued a report in September 1988 which called for a 30 percent reduction in the debt burden of heavily indebted countries. *Financial Times,* September 2, 1988.

[15] *Third World Debt: A Reexamination of Long-Term Management,* Report of the Third World Debt Panel of the Economic Policy Council of UNA-USA, September 7, 1988.

[16] *The Washington Post,* May 28, 1988.

[17] *Financial Times,* May 21, 1988.

[18] *The Washington Post,* May 28, 1988.

[19] *Financial Times,* November 6, 1987.

man for the business community, recently declared that business would back "unilateral" actions by the government to reduce Mexico's external debt payments if creditors do not voluntarily accept such a change.[20]

The United States has already showed some recognition of this growing consensus. United States policy has already moved cautiously toward accommodating Mexican needs for debt reduction by agreeing to back the Morgan "debt-for-bonds" swap plan with zero-coupon Treasury securities. Further movement in this same direction will doubtless be needed in the months ahead. For, as one observer of United States-Mexican relations put it recently:

> . . . a real and unavoidable dilemma exists in Mexico between economic growth and debt servicing. This dilemma will not be resolved unless a major departure from the current conditions of payment is unilaterally imposed by Mexico, agreed to by the United States, and accepted by the creditors.[21]

Trade

If discovering a cooperative solution to the problem of the debt is the short-term economic imperative in United States-Mexican economic relations, finding ways to improve trade relations between the countries is clearly the principal long-term economic issue. Over the long run, expanded trade between the United States and Mexico holds great potential for mutual advantage.

From the United States perspective, Mexico represents a large potential market where United States firms enjoy a natural competitive advantage. Mexico already ranks third as a destination for United States exports, even after six years of drastic import restraint, which, as Figure 18 shows, has cut badly into United States export sales to Mexico. A Mexico which was growing once again could easily help to maintain the export boom which the United States needs to reduce its own large external trade imbalance.

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[20] *The Washington Post*, May 28, 1988.

[21] Adolfo Aguilar Zinser, "Mexico and the United States: The Lost Path," in Susan K. Purcell ed. "*Mexico in Transition*, Council on Foreign Relations, 1988, p. 127.

Figure 18

From the Mexican perspective, opening the economy to external trade is a central part of the strategy for economic growth and structural reform. Competition from imports is seen as providing a needed tonic for inefficient Mexican firms, while export markets are seen as a principal source of demand growth, given the reality that domestic demand growth is sacrificed to the demands of price stabilization, and investment is hampered by excess capacity, tight money and trade pressure on profitability.

For Mexico, export growth means selling more in the United States market. Figure 19 shows that the United States remains by far the largest market for Mexican exports in general, and for non-petroleum exports in particular. Over the past several years, the government has been attempting to encourage diversification in the country's export markets. During the early 1980's, these efforts were hampered by the close ties between the peso and the dollar during a period of dollar appreciation. Since 1985, however, the declining dollar and the further depreciation of the peso should have worked to bolster Mexican exports to non-United States markets. Despite these advantages, however, Mexican industry remains closely tied to the United States market.

Figure 19

U.S. SHARE OF MEXICAN NON-OIL EXPORTS

Because of these close connections, an export-led strategy for Mexico requires both growth in the United States market for imports and continued openness of the border to Mexican products. Both of these issues are sources of concern for Mexico. The United States is now in the sixth year of a recovery which is very long by postwar standards. At the same time, the United States is in the middle of a necessary correction of its external trade deficit. A recession in the United States, or an increase in trade barriers, would severely compromise any hope for an export-led recovery in Mexico.

Despite these concerns, Mexico has so far been remarkably committed to a strategy of trade liberalization and outward orientation. Mexico's decision to join the GATT, to drop tariff rates and eliminate quantitative import restraints has made it among the most open of Third World economies. These moves also create intense pressure on Mexican firms to meet international competition in the domestic market, a necessary first step toward building an industrial structure capable of competing effectively in international markets.

These changes have created a climate of great concern about trade on both sides of the border. On the Mexican side, complaints are frequently heard that import liberalization will turn Mexico into an economic colony of the United States—a "Puerto Rico writ

large" in the words of one opposition politician.[22] Many in Mexico believe that liberalization has gone too far, as evidence by the appearance of cheap Far Eastern toys on the carts of street vendors and the closing of Mexican production facilities as international parent firms find that it is cheaper to import goods in today's liberalized environment than to produce them in Mexico.

On the United States side, the concern is that an outward-looking Mexico will pose challenges similar to those posed by Taiwan or Korea. According to David Hale, Chief Economist for Kemper Financial Services: "The great economic surprise of the 1990's may be a shift in Mexico's economic status from an American debt problem to an American trade problem." [23] And Professor Paul Krugman of MIT recently observed: "If the Salinas team gets its way, Mexico will try to turn itself into a kind of Latin American Taiwan." [24]

These concerns on both sides of the border have the potential for jeopardizing current moves toward expanded trade between the two countries. Mexico's recent decision to drop tariffs to an average of 20 percent, even though Mexico's GATT commitments were for only a reduction to 50 percent, has come under criticism inside the country and generated demands to return to the higher tariff levels set by the GATT agreement once the intense fight against inflation is over. This step would have a negative impact both on U.S. exports to Mexico and on the strategy of competitive opening of the Mexican economy being pursued by the current government. Similarly, on the U.S. side of the border, there have been growing calls for increased limits on a broad range of Mexican exports, particularly those making extensive use of Mexican petrochemical inputs.

In this climate of concern on both sides of the border, maintaining good relations between the countries while continuing to expand trade means that the search for mutually beneficial trade agreements needs to be accelerated. Trade negotiators need to look for opportunities to strike bargains which keep Mexico moving in the direction of liberalization while addressing Mexican concerns for market access in the United States.

Recent developments in trade relations between the countries make it increasingly likely that such agreements can be found. The recent signing of a "framework agreement" between the two countries gives negotiators a new and more cooperative context in which to examine trade issues. In this improved negotiating environment, it should be possible to make progress on a number of current trade issues. The principal Mexican concerns about current trade policy in the United States involve quantitative restraints on items such as steel and textiles, tariff barriers on auto parts and chemicals, seasonal and phyto-sanitary restraints on agricultural exports, and access to duty-free imports under the Generalized System of Preferences. United States concerns about Mexican trade policy involve maintaining current low tariff rates, protection for

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[22] Heberto Castillo, President of the Mexican Worker's Party, quoted in the *Wall Street Journal*, September 20, 1985.
[23] *Business Week*, September 14, 1987.
[24] *Los Angeles Times*, July 24, 1988.

intellectual property rights, the permanence of recent tariff reductions, subsidies for Mexican exports, regulations governing domestic content and foreign investment.

It should be emphasized that progress on obtaining mutually beneficial results in the trade area will depend critically on the ability to restart the growth process in Mexico. A rapidly growing Mexico is much less likely to become a trade problem for the United States, and much more likely to be a spur to United States exports.

A resumption of growth in Mexico would substantially reduce the prospects for the country becoming another chronic-surplus country like Taiwan. Mexico, a much larger country, has tremendous potential for a growing internal market if overall economic conditions stabilize. For most Mexican businesses, exports sales are a short-term necessity until domestic demand growth regains its momentum. Expansion of exports in Mexico also is likely to require a large expansion in imports, since the Mexican domestic capital goods industry has been devastated by the austerity of the 1980's and capital-goods imports have been severely compressed as the country struggled to conserve foreign exchange for debt service. A leading Mexican business economist laid these fears to rest when he pointed out: "Mexico is like a sponge: If it grows, it soaks up imports." [25]

For these reasons, therefore, expanded trade with Mexico need not produce an increased imbalance in trade in Mexico's favor. Some indication of the magnitude of possible U.S. trade gains can be seen by examining the data in Figure 20. The chart shows clearly that upturns in Mexican economic growth are followed by even more impressive percentage increases in Mexican imports of United States products. During the early 1970's, before the oil boom and before the massive external borrowing, United States exports to Mexico grew at an average rate of 20 percent per year. If Mexico in the 1990's were to return to its earlier pattern of sustained positive economic growth, and were to maintain the current trade liberalizing measures, a return to 20 percent annual growth in United States exports to Mexico would certainly seem an attainable goal. Few other markets for U.S. exports can be expected to grow at these rates, and the steady addition of some $3 to $5 billion to U.S. exports would help make a needed positive contribution toward reducing our own large trade deficit.

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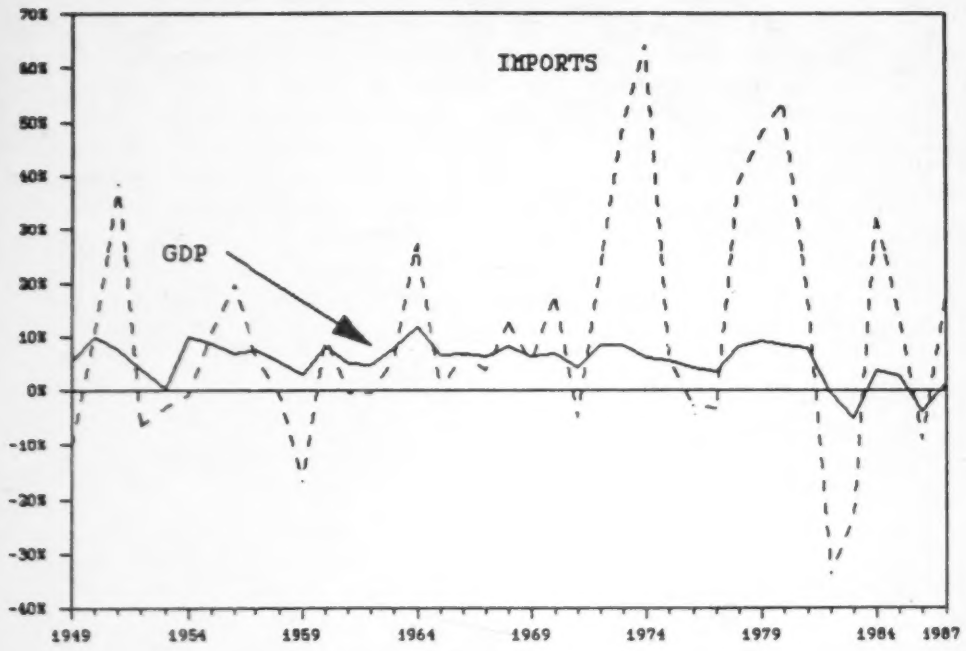
[25] Rogelio Ramirez de la O, quoted in *U.S. News & World Report*, July 4, 1988.

Figure 20

GROWTH RATES FOR GDP AND IMPORTS



SOURCE: IMF

But such a development would depend on resumption in Mexico of a healthy pace of overall economic growth, and on United States-Mexican agreement on a broad range of trade issues. A stagnant internal market will only intensify pressure from Mexican industries for a return of trade protection, and a continuation of the debt-induced squeeze on imports could force Mexico into earning a large trade surplus, largely at the expense of the United States.

To reap the mutual benefits of trade expansion, therefore, trade must be *part of* a larger strategy for growth in Mexico. To rely on exports and a large trade surplus as Mexico's growth engine is likely to prove self-defeating, since this would require unacceptable deterioration in the United States trade position. Coupled with macroeconomic reform in Mexico and a viable solution to the external resource problem, trade can be a source of benefit to both the United States and Mexico. Absent such a broader strategy, export expansion by Mexico could be a major source of strain in relations between the countries.

Free Trade With Mexico?

Over the longer run, there is considerable interest in both the United States and Mexico about the potential for a complete elimination of trade barriers between the countries. Resistance to such

an idea is also high, with United States interests concerned about a rapid shift of production to low-wage Mexico, and Mexican interests concerned about economic domination by the United States. But if economic growth in the two countries causes renewed growth in domestic incomes in Mexico while putting pressure on the slow-growing labor force in the United States, interest is likely to build in the mutual advantages to such economic integration.

Economic and demographic complementarities are tending to drive the two countries toward closer economic cooperation. As Figure 21 and Figure 22 show, by the year 2020, both the United States and Mexico have population problems: Mexico's population is "bottom heavy," with a rapidly growing working age population needing employment opportunities, while the United States profile is "top heavy," with a large elderly and dependent population being supported by a much smaller working-age population.

Figure 21

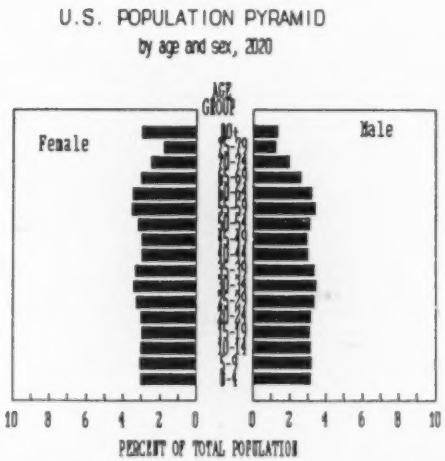
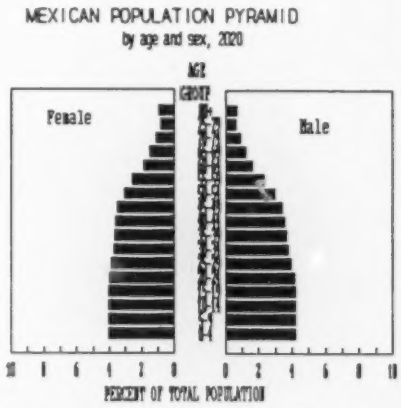


Figure 22



Both countries would benefit significantly if their combined economic policies during the next few decades produced an increased rate of overall economic growth. Mexico would benefit from an improved ability to absorb labor into its domestic economy, and the United States would benefit from increased incomes out of which to save for the retirement of our aging population.

A possible route toward increasing both countries' growth rates might involve the development of significantly closer trade ties between the United States and Mexico. There is a clear tendency in the world economy toward the development of regional trading relationships. Europe's full integration in 1992 is producing great rewards for firms located inside Europe, but there is growing concern that trade will diminish with nations outside Europe.[26] Japan ap-

[26] A recent paper on U.S. competitiveness observed: "Moreover, Europe has been expanding and closing. . . . For the United States this expansion of the European Common Market is an adverse development," Rudiger Dornbusch, James Poterba, Lawrence Summers, "The Case for Manufacturing in America's Future," Eastman Kodak, 1988, p. 30.

pears to be working toward a similar level of regional integration in Asia.

As the world's largest market economy, the United States has traditionally paid little attention to the need for regional cooperation, but the recent free-trade agreement negotiated with Canada suggests that this traditional orientation may be changing. If the Canadian arrangement proves advantageous for both countries, there is likely to be increased interest in the creation of a broader "North-American" free trade area, embracing Canada, the United States and Mexico.

Proponents of the idea argue that such a regional grouping would be a formidable competitor in international markets, although, as in Europe, there would be difficult transitional problems of allocating resources and employment within the free trade area. And, as with both the European Community and the current Canadian free trade agreement, any such regional trading block would involve many areas in which commerce was not entirely "free," and where national interests and national economic policies would continue to influence economic activity.

The increasing formation of regional trading blocks elsewhere makes it likely that over the next decade or two there will be substantial interest in drawing Mexico into the area created by the United States-Canada agreement. The policy question for the future will thus be how to negotiate agreements which recognize these economic realities while respecting the national interests of parties on both sides of the border.

Greater cooperation between the two economies might also make it possible to make substantial progress on important issues which affect the quality of life in both countries. Pollution, in particular, is a problem which does not respect current geographical barriers, and one which requires joint solutions which present political and economic realities make difficult.

Rapid economic growth in the north of Mexico, along the border with the United States, has rapidly outstripped Mexico's abilities to finance infrastructure. This means an acute shortage of potable water in Mexican border towns, and an inability to dispose adequately of the sewage which such population concentrations create. Breaks in antiquated sewage lines in Tijuana forced beach quarantines for 307 days in 1981, 219 in 1982, 294 in 1983, and the sewage problem was so acute in the Nogales area that both countries worked out a joint-financing arrangement for a sewage treatment facility.

Similar problems exist with air pollution and toxic waste disposal. At the current level of integration between the economies, different regulations and different resource availabilities frustrate efforts to cleanup and provide a competitive advantage to high-polluting industries. A higher degree of economic cooperation between the economies should permit expansion of trans-border infrastructure and an improved environment in the region.

These advantages suggest strongly that greater economic cooperation between the United States and Mexico holds great promise for improving well-being on both sides of the border. This realization was expressed by the United States and Mexican private-

sector leaders who spearheaded the negotiations leading to the framework agreement:

The agreement reflects a recognition by our two countries that they share a joint destiny and that the prosperity of both countries will be increased as they combine their resources, their technology, and the energy of their people to produce goods and services for world markets. [27]

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[27] Robert E. Herzstein and Gustavo de la Serna, PR Newswire, November 6, 1987.

VIII. CONCLUSION

Mexico is in the midst of a truly exceptional period of change in both its economic and political life. Painful economic policies are transforming the structure of the Mexican economy, but many of the most difficult tasks lie ahead. No large economies with embedded triple-digit inflation have managed to combine price stability and economic growth. Few have succeeded in opening their political systems during periods of excessive economic distress. Mexico will need to break new ground in economic policy and maintain a delicate balance between economic reform and political liberalization. For its part, the United States will be challenged to develop policies toward Mexico which safeguard important United States strategic and economic interests and support the kinds of policy reform presently underway in Mexico.

The key to policy in both countries is economic growth. A return to historic rates of growth in Mexico will ease the process of economic reform and improve prospects for broader democratic participation. Resumption of growth in Mexico will also ease trade frictions between the two countries, and permit a realistic consideration of their long-run common economic interests. Finding the path to renewed growth will, however, require the active support of the United States in the areas of debt and trade. Without such external support, it is difficult to see how Mexico will be able to maintain the rate of growth needed to sustain the momentum of reform.

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